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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

CHURCH OF SPIRITUAL TECHNOLOGY,
Petitioner,

v.

THE UNITED STATES,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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QUESTIONS PRESENTED

Pursuant to 26 U.S.C. § 501(c)(3), an organization must be "organized and operated" exclusively for one or more of the exempt purposes listed therein to be exempt from taxation. Pursuant to 26 U.S.C. § 7428, an organization may seek a declaratory judgment that it is exempt from taxation. The questions presented are:

1. Whether a court may hold that an organization is not operated exclusively for exempt purposes, based on suspicion of an unstated non-exempt purpose, where the court holds that all of the organization's activities throughout its history have been exclusively to advance its stated exempt purposes?

2. Whether in a declaratory judgment proceeding pursuant to 26 U.S.C. § 7428 a court may hold an organization to have failed to carry its burden of establishing its exempt status on grounds not set forth in the final adverse ruling of the Internal Revenue Service and advanced for the first time at oral argument on the merits before the trial court?

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Church of Spiritual Technology ("CST")[1] petitions for a writ of certiorari to review the opinion of the United States Court of Appeals for the Federal Circuit.

Opinions Below

The order of the United States Court of Appeals for the Federal Circuit ("the appeals court") denying CST's petition for rehearing (D-66) is unreported. The *per curiam* opinion of the court of appeals (A-1) affirming the opinion and judgment of the United States Court of Federal Claims ("the trial court") is unreported. The opinion of the trial court (B-2) is reported at 26 Cl. Ct. 713 (1992).

[1] CST is incorporated under the California Nonprofit Religious Corporation Act and has no parent or subsidiary companies.

Jurisdiction

The *per curiam* opinion of the appeals court (A-1) affirming the opinion and judgment of the trial court is dated March 29, 1993. The order of the appeals court denying CST's timely petition for rehearing (D-66) was filed on April 26, 1993. On July 14, 1993, Chief Justice Rehnquist extended the time within which CST may file a petition for a writ of certiorari to and including August 24, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Statutory Provisions Involved

26 U.S.C. § 501 provides in pertinent part:

(a) Exemption from taxation. An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

* * *

(c) List of exempt organizations. The following organizations are referred to in subsection (a):

* * *

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements),

any political campaign on behalf of (or in opposition to) any candidate for public office.

26 U.S.C. § 7428 provides in pertinent part:

(a) Creation of remedy. In a case of actual controversy involving-

(1) a determination by the Secretary-

(A) with respect to the initial qualification or continuing qualification of an organization as an organization described in section 501(c)(3) which is exempt from tax under section 501(a) or as an organization described in section 170(c)(2). . ., or

(2) a failure by the Secretary to make a determination with respect to an issue referred to in paragraph (1),

upon the filing of an appropriate pleading, the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia may make a declaration with respect to such initial qualification or continuing qualification or with respect to such initial classification or continuing classification. Any such declaration shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Claims Court, as the case may be, and shall be reviewable as such. For purposes of this section, a determination with respect to a continuing qualification or continuing classification includes any revocation of or other change in a qualification or classification.

Statement

CST is a church of the Scientology religion. Scientology was founded in 1950 by L. Ron Hubbard (B-3). A fundamental tenet of Scientology is that man is an immortal spiritual being. Through the sacraments of Scientology, an individual attains

certainty of immortality and freedom from spiritual burdens (B-4).

L. Ron Hubbard's recorded written and spoken words on religious matters are the Scriptures of Scientology (B-3). These voluminous Scriptures deal with ministration of religious services and matters of ecclesiastical administration, and consist of over 11,000 published issues, over 120 published volumes of compilations, over 3,000 tape recordings of Mr. Hubbard's lectures, and over 110 instructional films.

In Scientology, spiritual salvation can be attained only by the orthodox practice of the religion, which means following the path of spiritual awareness Mr. Hubbard outlined in the Scriptures. The portion of the Scriptures that constitutes the upper levels of spiritual awareness in Scientology is called its "Advanced Technology"(B-4). Scientology churches assure parishioners that their religious services are orthodox by providing them under specific religious marks.

Founded in 1982, CST is unique among the churches of Scientology. CST neither ministers religious services to parishioners nor provides support services to other churches. Rather, CST's sole objective and function is to preserve and protect the millions of words of writings, recordings and film that make up the Scriptures of Scientology to ensure that the religion can be practiced by all generations to come (B-14).

To accomplish its objective, CST conducts a sophisticated program to preserve original Scriptural materials it has collected, to reproduce Scriptural materials on special long-term archival media, and to store preserved original materials and archival reproductions in remote, secure underground vaults (B-16-18). Through its fiscal year ending April 30, 1987, CST had spent approximately $14.6 million to carry out and support its program. As of May 1987, CST estimated it would need to spend up to an additional $36 million to complete the preservation projects it was planning at that time and future projects.

In 1982, Mr. Hubbard implemented plans to ensure the orthodoxy of the Scientology religion after his death by giving the Scientology religious marks and the right to use the Advanced Technology in the United States to a separate Scientology church, Religious Technology Center ("RTC")(B-12). At the same time, Mr. Hubbard gave CST limited options to acquire RTC's rights to the Advanced Technology and Scientology religious marks under any one of three narrowly-defined conditions (B-13).

On August 26, 1983, CST applied to the Internal Revenue Service ("IRS") for a ruling that it qualified for tax exemption under 26 U.S.C. § 501(c)(3)(hereafter, "section 501(c)(3)") (B-2). On January 7, 1986, the IRS issued CST an initial adverse ruling, relying principally upon alleged private benefit to Mr. Hubbard.

Barely two weeks later, on January 24, 1986, Mr. Hubbard died (B-12). His Estate included his copyrights to the Scriptures and his residual rights to the Scientology Marks and Advanced Technology. In his Will, Mr. Hubbard bequeathed CST the bulk of his Estate if CST obtains recognition of its tax-exempt status (B-13). If CST does not, Mr. Hubbard's Estate is to be distributed to one or more section 501(c)(3) Scientology organizations.

On July 8, 1988, the IRS issued its final adverse ruling (B-2-3), which concluded that CST had failed to establish that it operates exclusively for exempt purposes and that CST had failed to establish that it is not operated for the benefit of private interests and that its net earnings did not inure to the benefit of private individuals. The ruling also made specific findings that CST is "operated for a substantial non-exempt commercial purpose," that CST is "operated for the benefit of private interests" and that CST's "net earnings inure to the benefit of private individuals." The final ruling made no mention of CST's options, nor did it suggest in any way that CST's primary purpose

was to obtain tax-exempt status and exercise its options to shelter the income of non-exempt Scientology entities from taxation. The final ruling did not conclude that CST had failed the organizational test set forth in section 501(c)(3).

On October 6, 1988, CST filed with the trial court its complaint for a declaratory judgment.[2] The government's answer did not raise any ground for denial of exemption not stated in the IRS's final adverse ruling.

During oral argument on the merits before the trial court, however, government counsel raised a new ground for denial of exemption: that CST's preservation and archival activities were a mere pretext and that its true purpose was to obtain tax-exempt status so that it could then exercise its options in order to serve the financial objectives of non-exempt Scientology entities. On May 26, 1992, the trial court entered its opinion on the merits denying CST declaratory judgment based on the government's new ground. On June 29, 1992, the court entered a revised opinion (B-2) and new judgment (E-67) against CST, denying CST's June 5, 1992 motion for reconsideration. The court also issued an order on reconsideration (C-54) on June 29, 1992.

The appeals court issued a *per curiam* opinion dated March 29, 1993 (A-1) affirming the opinion and judgment of the trial court. By an order dated April 26, 1993 (D-66), the appeals court denied CST's petition for rehearing.

REASONS FOR GRANTING THE WRIT

This petition presents important substantive and procedural issues in the Government's administration of the provisions of the Internal Revenue Code granting exemption from federal corporate income tax. Equally important, however, are the First Amendment concerns arising from the government's treatment of a new church propagating nonmajoritarian religious doctrine.

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[2] The trial court had jurisdiction over CST's suit under 26 U.S.C. § 7428 (hereafter, "section 7428") and under 28 U.S.C. §§ 1507 and 2201.

For as long as there has been a federal corporate income tax, Congress has expressly exempted churches and other religious organizations. *See Walz v. Tax Commission*, 397 U.S. 664, 676 & n.4 (1970). Although such an exemption is constitutional only as part of a larger pattern of exemption for public benefit institutions, *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1, 11-17 (1989) (plurality opinion of Brennan, J.), exemption for churches nevertheless stands on a different footing because it "operate[s] affirmatively to help guarantee the free exercise of all forms of religious belief." *Walz*, 397 U.S. at 678. The "benevolent neutrality toward churches and religious exercise" reflected in the historical tradition of exemption for churches is permissible "so long as none [is] favored over others and none suffer[s] interference." *Walz*, 397 U.S. at 676-77.

In two decisions in 1974, the Court held that organizations claiming tax exemption could not obtain pre-enforcement judicial review of adverse IRS administrative determinations.[3] The Court so held despite its recognition that its decision left far too much discretion with the IRS.[4] In response, Congress in 1976 enacted section 7428 "in order to provide an effective appeal from an Internal Revenue Service determination that an organization is not exempt from tax."[5]

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[3] *Bob Jones University v. Simon*, 416 U.S. 725 (1974), and *Alexander v. "Americans United" Inc.*, 416 U.S. 752 (1974).

[4] *Bob Jones Univ.*, 416 U.S. at 749-50 ("The degree of bureaucratic control that, practically speaking, has been placed in the Service over [organizations claiming exemption] is susceptable of abuse, regardless of how conscientiously the Service may attempt to carry out its responsibilities."); *Alexander v. "Americans United" Inc.*, 416 U.S. at 774-775 ("[W]here the philanthropic organization is concerned, there appears to be little to circumscribe the almost unfettered power of the Commissioner. This may be very well so long as one subscribes to the particular brand of social policy the Commissioner happens to be advocating at the time . . . but application of our tax laws should not operate in so fickle a fashion.") (Blackmun, J., dissenting).

[5] H.R. Rep. No. 658, 94th Cong., 1st Sess. 284 (1975), reprinted in 1976-3 C.B. (Vol. 2) 976; S. Rep. No. 938, 94th Cong., 2d Sess. 587 (1976), *reprinted in* 1976-3 C.B. (Vol. 3) 625.

In the seventeen years since its enactment, this Court has not had occasion to review the scheme Congress adopted for declaratory judgment review of IRS exemption determinations. The case for review here is compelling because not only do the decisions of the lower courts misapply the substantive provisions for tax exemption under section 501(c)(3), they severely undermine the purposes Congress sought to accomplish in enacting section 7428. By basing their decisions on a ground that the IRS had never raised during CST's administrative proceeding, the lower courts also denied CST due process of law.[6] That the lower courts did so in a case involving a church of an unconventional religious denomination further calls for the writ to be granted, because CST has "suffered interference" and has been disfavored in relation to other churches. *Walz*, 397 U.S. at 676-77. For these reasons, CST respectfully submits that the Court should grant this petition.

I. THE TRIAL COURT MISAPPLIED 26 U.S.C. § 501(C)(3) BY HOLDING CST TO BE NONEXEMPT ON A GROUND WHICH, ALTHOUGH CLASSIFIED AS OPERATIONAL, WAS IN FACT ORGANIZATIONAL. SINCE CST HAD NOT RECEIVED NOTICE THAT ITS ORGANIZATIONAL QUALIFICATIONS WERE AT ISSUE, ITS RIGHT TO DUE PROCESS WAS VIOLATED.

To be exempt from taxation under section 501(c)(3), an organization must be "organized and operated" exclusively for one or more specified exempt purposes. Thus, an organization must pass two separate tests, one as to its organization and

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[6] To receive due process of law, a party must have reasonable notice of the issues to be litigated or it will not have an adequate opportunity to prepare its case. *See, e.g., Mathews v. Eldridge*, 424 U.S. 319, 333 (1976) ("The fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner.'") (citations omitted).

another as to its operations. The trial court misapplied these tests.

An organization meets the "organizational" test if its articles of incorporation (or other organizing documents) limit its purpose to one or more of the exempt purposes listed in section 501(c)(3) and if they "[d]o not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes." Treas. Reg. § 1.501(c)(3)-1(b)(1)(i). Thus, if the organization is empowered to engage in a substantial non-exempt purpose, it fails the organizational test.

In addition, however, the organizational test includes the question of whether an organization was created to carry out a purpose not set forth in its organizational documents:

> [I]n applying the organizational test, a court is not necessarily bound by the recitals in the certificate of incorporation, and in an appropriate case may look beyond the four corners of the creating instrument and consider extrinsic evidence.
>
> > To grant or deny tax benefits to organizations upon a basis of recitations in a charter or certificate would not seem to accomplish what Congress was getting at. The issue of "organized," . . . is primarily a question of fact not to be determined merely by an examination of the certificate of incorporation *but by the actual objects motivating the organization* and the subsequent conduct of the organization.[7]

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[7] *Taxation With Representation v. United States*, 585 F.2d 1219, 1222 (4th Cir. 1978), *cert. denied*, 441 U.S. 905 (1979) (emphasis added) (quoting *Samuel Friedland Foundation v. United States*, 144 F. Supp. 74, 85 (D.N.J. 1956); *accord*, *Colorado State Chiropractic Society v. Commissioner*, 93 T.C. 487, 494-96 (1989); *Peoples Translation Service/Newsfront International v. Commissioner*, 72 T.C. 42, 47-48 (1979).

In contrast, the "operational" test requires that an organization engage "primarily" in activities that accomplish its exempt purpose and that not more than an "insubstantial part of its activities further a nonexempt purpose." Treas. Reg. § 1.501(c)(3)-1(c)(1). The operational test thus seeks to determine whether the organization's actual activities carry out the exempt purposes identified by the organizational test, or whether those activities carry out some other unstated, perhaps non-exempt, purpose. If an organization's actual activities and stated purposes conform, and the stated purposes are exemption related, then the operational test is met.[8]

Under this statutory scheme, it is clear that if an organization is alleged to have an unstated nonexempt purpose but conducts *no* activities in furtherance of such purpose, then the organization cannot be denied exemption on the grounds it has *operated* for such a purpose. Congress has made it equally clear that a favorable declaratory judgment "does not foreclose Service action for later years . . . if . . . the organization's operations have changed since the years to which the declaratory judgment applies, or (especially in the case of a new organization) if the organization *does not in operation* meet the requirements for qualification."[9] Thus, every court that has addressed the issue but those in the case below have consistently followed this express Congressional intent and have refused to speculate in declaratory judgment proceedings that an organization *might* operate in the future for an unstated nonexempt purpose.[10]

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[8] *Goldsboro Art League, Inc. v. Commissioner*, 75 T.C. 337, 343 (1980), *acq.*, 1986-2 C.B. 1; *Federation Pharmacy Services, Inc. v. Commissioner*, 72 T.C. 687, 691 (1979), *aff'd*, 625 F.2d 804, 807 (8th Cir. 1980); *est of Hawaii v. Commissioner*, 71 T.C. 1067, 1078-82 (1979), *aff'd*, 647 F.2d 170 (9th Cir. 1981).

[9] H.R. Rep. No. 658, 94th Cong., 1st Sess. 286 (1975), *reprinted in* 1976-3 C.B. (Vol. 2) 978; S. Rep. No. 938, 94th Cong., 2d Sess. 588 (1976), *reprinted in* 1976-3 C.B. (Vol. 3) 626 (emphasis added).

[10] *Church of the Visible Intelligence That Governs the Universe v. United States*, 4 Cl. Ct. 55, 63 (1983) ("Plaintiff is expressly restricted from

The trial court held that CST failed the operational test on the ground that its primary purpose is not to preserve and protect the Scientology Scriptures but to serve the financial goals of other Scientology entities:

> [CST] has not demonstrated that it is *operated* exclusively for tax-exempt purposes. The administrative record persuades the court that CST was founded for the primary purpose of gaining tax-exempt status to serve the financial goals of other, non-exempt entities, and that CST's archiving activities are secondary to its obtaining tax exemption and would not of themselves qualify CST as a tax-exempt organization under I.R.C. § 501(c)(3).

(B-3) (emphasis added).

The trial court's conclusion that CST is not operated exclusively for exempt purposes was based on CST's options to acquire RTC's rights to the Advanced Technology and Scientology religious marks. The court speculated that the options would be the means by which CST would "serve the financial goals of other, non-exempt entities":

> [T]he court is struck by the centripetal force that will be generated *should* CST obtain tax-exempt status, and *should* it choose to exercise its options to take over assets from RTC. Armed with the trademarks and publishing rights, and with tax-exempt status, CST will be poised in the center of all of Scientology's financial resources, in position to exert a strong

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using its earnings to benefit its officers . . . . [T]he court will not speculate now whether future pay limits will be reasonable."); *see also National Foundation, Inc. v. United States*, 13 Cl. Ct. 486 (1987) (rejecting the possibility of unspecified non-exempt activities); *Junaluska Assembly Housing, Inc. v. Commissioner*, 86 T.C. 1114, 1123, 1125 (1986) ("We are satisfied . . . that petitioner has not *in the period before this Court* . . . engaged in activities to further a substantial non-exempt purpose.") (emphasis added).

> gravitational force on Scientology's income-producing assets. . . .
>
> . . . The *potential* for abuse of the options and copyrights therefore is considerable.

(B-46,47) (emphasis added).

However, because CST has never exercised or utilized the options, or otherwise engaged in *any* activity with respect to the options, the options have not in any way constituted any part of CST's actual activities. Rather, as the trial court specifically acknowledged, since no nonexempt activity could result from the options until they were exercised, they represented at most a "potential" act rather than an actual act.

Thus, any issue presented by the options would lie under the *organizational* test rather than the operational test. But CST was never given notice during the administrative proceeding before the IRS of any issue as to its organizational qualifications, nor of the "factual" grounds ultimately identified by the trial court. Because CST was provided no opportunity to build a record on an issue under the organizational test, the trial court not only misapplied section 501(c)(3) when it based its holding on an organizational issue but it also denied CST due process.[11]

Because the IRS never gave CST notice that its organizational qualifications were at issue, the *only* legitimate question before the trial court was whether CST's actual activities manifested a substantial non-exempt purpose. The lower court specifically found that most, if not all, of CST's actual activities furthered its exempt religious purposes (B-40). A colloquy between government counsel and the appeals court also makes clear that the government's argument and the courts' decisions were not based on any actual activity conducted by CST that

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[11] The trial court itself, apparently not understanding the difference between the organizational and operational tests, actually held that CST had met the organizational test (B-35), which the government itself had conceded.

furthered a nonexempt purpose.[12] None of the opinions below, nor any of the government's briefs or other pleadings, nor CST's record before the IRS identifies any act by CST that furthers any purpose other than the religious purposes stated in its organizational documents.

II. THE TRIAL COURT MISAPPLIED 26 U.S.C. § 7428 BY HOLDING CST TO BE NON-EXEMPT ON A GROUND NOT SET FORTH IN THE INTERNAL REVENUE SERVICE'S FINAL ADVERSE RULING, THEREBY VIOLATING CST'S RIGHT TO DUE PROCESS.

A. The Trial Court Was Limited to the Internal Revenue Service's Final Adverse Ruling as the Basis For Its Decision.

In enacting section 7428, Congress specifically provided that a reviewing court must base its decision "upon the reasons provided by the Internal Revenue Service in its notice . . . or

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[12] THE COURT: You agree the archiving is okay?

MR. RAPP: There is certainly nothing wrong with the archiving. Remember (interruption) . . .

THE COURT: You have to go beyond archiving and find that they are doing something else now?

MR. RAPP: No, I don't think that we have to find that they are doing anything else now (interruption) . . .

THE COURT: Then what is it we have to find?

MR. RAPP: We have to find what the purpose of the organization is in its operation, and Judge Bruggink found (interruption) . . .

THE COURT: You have to find out that their "now purpose" goes beyond what they are currently now doing.

MR. RAPP: Precisely, Your Honor . . . .

(F-88).

based upon any new argument which the Service may wish to introduce at the time of trial."[13]

The rules governing the allocation of the burden of proof that Congress intended be followed in actions under section 7428[14] and that the Court of Federal Claims has chosen to follow[15] impose the burden of proof on the organization "as to the grounds set forth in the notice of determination."[16] The government, on the other hand, bears the burden of proof "as to any ground . . . which is not stated in the notice of determination."[17] Thus, it generally is appropriate to allow the government to raise new grounds at the time of trial because the government will bear the risk of nonpersuasion if the record does not support its new allegations.[18] This allocation of the burden of proof serves the fundamental due process function of ensuring that an organization has notice of and adequate opportunity to respond to substantive grounds asserted by the IRS.[19]

The test for a new ground is whether the applicant was adequately apprised of the underlying factual basis so that it had the opportunity to present evidence and argument during the administrative proceeding.[20] Thus, whether an IRS position

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[13] H.R. Rep. No. 658 at 285, 1976-3 C.B. (Vol. 2) at 977; S. Rep. No. 938 at 588, 1976-3 C.B. (Vol. 3) at 626.

[14] H.R. Rep. No. 658 at 285-86, 1976-3 C.B. (Vol. 2) at 977-78 ("The burden-of-proof rules . . . should conform to the rules that the Tax Court develops with regard to declaratory judgment suits as to retirement plans."); S. Rep. No. 938 at 588, 1976-3 C.B. (Vol. 3) at 626 (same).

[15] *See, e.g., Church of the Visible Intelligence*, 4 Cl. Ct. at 60.

[16] Tax Court Rule 217(c)(2)(A).

[17] Tax Court Rule 217(c)(2)(B).

[18] *Dumaine Farms v. Commissioner*, 73 T.C. 650, 660 (1980).

[19] *Peoples Translation Serv./Newsfront Int'l v. Commissioner*, 72 T.C. 42, 51 (1979).

[20] *See Virginia Educ. Fund v. Commissioner*, 85 T.C. 743, 751 (1985) ("[P]etitioner was well aware from the outset [of] respondent's sole and

was raised in the final adverse ruling, so that the organization bears the burden of proof, necessarily turns on the factual grounds the IRS identified in its determination:

> The role of the IRS is not simply to develop evidence and then make bald faced conclusions. By doing so, the IRS would leave it to the Court to ascertain what evidence in the record could support those conclusions. In effect, this makes the Court the finder of fact in the first instance. That is not the Court's function in this case. There is a difference between performing a *de novo* review and being the initial finder of fact.[21]

The trial court was obligated to adhere to the parameters Congress established for section 7428.[22] The court exceeded these parameters by basing its decision on a new ground which the IRS had never raised with CST and as to which the court did not require the IRS to bear the burden of proof. The appeals court not only perpetuated the lower court's error, it in fact compounded it: By expressly holding that CST failed to establish that it was organized for exempt purposes, it made clear it recognized that its endorsement of the unstated, nonexempt purpose found by the lower went to the organizational test, not the operational test. In so doing, it expressly found CST to have

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unambiguous ground for revocation"), *aff'd*, 799 F.2d 903 (4th Cir. 1986); *Dumaine Farms*, 73 T.C. at 659-60 (organization on notice because new ground was expressly raised in IRS answer; factual basis for new ground reflected in documentation required with exemption application); *Peoples Translation Serv.*, 72 T.C. at 51 ("Petitioner has had no opportunity to answer [the new ground] with factual data.").

[21] *Airlie Found., Inc. v. United States*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,462 (D.D.C. 1992) (remanding case for an explanation by the IRS as to the factual grounds in the administrative record for its conclusions).

[22] *See, e.g., Bender v. Williamsport Area School Dist.*, 475 U.S. 534, 541 (1986); *Switchmen's Union of N. America v. National Mediation Bd.*, 320 U.S. 297, 301, 304-06 (1943).

failed to carry its burden of proof on a new issue not even properly before the court.

B. The Trial Court Based its Decision on Reasons Not Set Forth in the Internal Revenue Service's Final Adverse Ruling, Thereby Violating CST's Right to Due Process.

As noted in Section I above, the trial court's basic holding was that:

> CST was founded for the primary purpose of gaining tax-exempt status to serve the financial goals of other, non-exempt entities, and that CST's archiving activities are secondary to its obtaining tax exemption and would not of themselves qualify CST as a tax-exempt organization under I.R.C. § 501(c)(3).

(B-3).

Although these reasons were never raised by the IRS at the administrative level or by the government in its answer or even in its brief on the merits, the court did not require the IRS to bear the burden of proof as to this new ground.

CST's complaint in the trial court set forth in detail how the IRS's stated reason for denying exemption for inurement and a "substantial nonexempt purpose" was not supported by the facts in the record. In its answer, the government simply denied CST's allegations but did not allege any additional reason to support the IRS's conclusion.

Before the trial court, CST also established that the IRS's stated reason for denying exemption was invalid. The government never responded to CST's proof, nor did it ever reassert the reason the IRS gave for denying CST's exemption. Instead, in its brief on the merits, the government asserted a new reason for denying exemption — that CST's purpose is to preserve the "inherently commercial" orthodox practice of Scientology. The government took this position even though it contradicted the

IRS's express determination that the organizational purpose stated in CST's articles of incorporation— to "ensure and maintain the purity and integrity of the religion of Scientology" — was an exempt religious purpose under section 501(c)(3).

At oral argument on the merits before the trial court, the government abandoned its prior arguments — conceding that there was nothing in the record showing inurement or that CST engaged in any commercial activity — and, as discussed above, constructed a new ground for denying exemption. It was on this new ground that the trial court determined that CST "was founded for the primary purpose of gaining tax-exempt status to serve the financial goals of other, non-exempt entities" (B-3).

The trial court did not base its holding on any ground stated in the IRS's final adverse ruling or any "new argument which the Service may wish to introduce at the time of the trial," which should have been stated in the government's answer.[23] Had the government properly raised this new ground at trial, it would have had to bear the burden of proof to show this was CST's actual purpose.[24] However, the government did not raise this new ground in its answer, or even in its brief on the merits; the ground therefore should not have been considered by the court at all, let alone have formed the basis for its decision.

Nor could the trial court ignore Congress' directive to limit its determination to the reasons given by the IRS on the justification that its ultimate conclusions "were based on the same evidence and underlying concerns as those of the Commis-

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[23] Tax Court Rule 213(a)(2) ("[T]he answer shall contain a clear and concise statement of every ground, together with the facts in support thereof, on which the Commissioner relies and has the burden of proof."); *Dumaine Farms*, 73 T.C. at 659-60; *see Church of Spiritual Technology v. United States*, 18 Cl. Ct. 247, 250 (1989) ("Congress expected . . . this court to follow the practices of the Tax Court.").

[24] Tax Court Rule 217(c)(2)(B).

sioner" (C-65). The trial court's reason for denying exemption differed from *every* reason ever advanced by the IRS or, up until oral argument, by the government. "Evidence" and "concerns" do not equal reasoning, and it is only the reasoning on which the IRS's conclusion is based that CST is required to challenge:

> The task of a reviewing court is made materially more difficult when it is denied the insights arising from adversarial comment on an agency rationale. Moreover, it is always uncertain when confronted with an *ex post* rationale, whether the agency would have in fact initially reached the result which it is called upon to justify retroactively. For these reasons, reviewing courts ordinarily decline to find agency decisions adequately supported by theories newly presented upon review.[25]

The trial court's acceptance of the government's *ex post* rationale denied CST any opportunity to demonstrate that the IRS's position had no merit. Because this action is not permitted by section 7428, the trial court denied CST due process.

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[25] *Blanco Oil Co. v. FERC*, 598 F.2d 152, 166, n.70 (D.C. Cir. 1979) (citation omitted).

CONCLUSION

The Court should be aware of the severe consequences to CST from the lower courts' decisions. Although the government attorney suggested in oral argument before the appeals court that CST could simply reapply to the IRS and make a fuller record, the IRS takes a much different position, namely, that exemption for CST in a new administrative proceeding would be effective *only* from the date of the new application. Under the IRS's position, even if CST were to reapply tomorrow, CST would have to litigate its exempt status for earlier years in deficiency or refund proceedings and would be required to establish as a threshold matter its entitlement to institute such a proceeding. Unless CST establishes its exempt status, it will not be eligible to receive Mr. Hubbard's generous, essential bequest. And if CST does not receive the bequest Mr. Hubbard intended for it, his careful plan to preserve his religious teachings for humanity for all time will be severely compromised.

The consequences to the structure and integrity of the administration of the laws of tax exemption are no less grave. By allowing the lower courts' decision to stand, this Court will permit the IRS to do to other exemption applicants what it did to CST: to keep it in administrative proceedings for nearly five years, only to abandon every factual and legal basis raised during that period and to concoct an *ex post* rationale at the last minute to which the organization can have no opportunity to respond. In short, allowing the lower courts' decisions to stand will thoroughly undermine Congress' purpose in enacting section 7428 by giving back to the IRS its "unfettered power" over exemption determinations[26] just as "susceptible of abuse"[27] as it was before 1976. Finally, allowing the lower courts' decisions to stand will send a clear message to the IRS that in the case of

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[26] *Alexander v. "Americans United" Inc.*, 416 U.S. 752, 744 (1974) (Blackmun, J., dissenting).

[27] *Bob Jones University v. Simon*, 416 U.S. 725, 750 (1974).

new organizations espousing nonmajoritarian doctrines it can pursue whatever "brand of social policy the Commissioner happens to be advocating at the time"[28] without risk of meaningful judicial scrutiny.

For the reasons stated, the petition for writ of certiorari should be granted.

Respectfully submitted,

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[28] *Alexander*, 416 U.S. at 775 (Blackmun, J., dissenting).

APPENDIX A
Opinion of the Court of Appeals

NOTE: Pursuant to Fed. Cir. R. 47.8, this disposition is not citable as precedent. It is a public record. The disposition will appear in tables published periodically.

United States Court of Appeals for the Federal Circuit

92-5155

CHURCH OF SPIRITUAL TECHNOLOGY,
Plaintiff-Appellant,

v.

THE UNITED STATES,
Defendant-Appellee.

DECIDED: March 29, 1993

PER CURIAM:

The Church of Spiritual Technology appeals the judgment of the United States Court of Federal Claims, 26 Cl. Ct. 713 (1992), sustaining the decision of the Commissioner of Internal Revenue that it was not entitled to tax-exempt status under I.R.C. § 501(c)(3) (1982). On the basis of the reasoning set out in the opinion of the Court of Federal Claims, we conclude that the Church of Spiritual Technology did not carry its burden of proving that it is both organized and operated exclusively for tax-exempt purposes, Treas. Reg. § 1.501(c)(3)-1(d)(1)(i)(a), and that it therefore did not establish its eligibility under I.R.C. § 501(c)(3). We *affirm*.

APPENDIX B
Opinion of the Court of Federal Claims

In the United States Claims Court

No. 581-88T
(Reissued June 29, 1992)[1]

CHURCH OF SPIRITUAL TECHNOLOGY
Tax; Exempt Organizations

Plaintiff,

v.

THE UNITED STATES

Defendant.

Monique E. Yingling, Washington, D.C., for plaintiff. Thomas C. Spring, of counsel.

W.C. Rapp, with whom were Assistant Attorney General Shirley D. Peterson and David Gustafson, for defendant.

OPINION

BRUGGINK, *Judge.*

This is an appeal from a decision rendered by the Commissioner of the Internal Revenue Service ("IRS"). The Church of Spiritual Technology ("CST"),[2] plaintiff, applied for tax-exempt status under I.R.C. § 501(c)(3) (1982) as a religious organization.[3] On July 8, 1988, the IRS issued its final adverse

[1]The opinion of May 26, 1992, was vacated and corrections were made pursuant to the Order on Reconsideration of June 29, 1992.

[2]A list of the acronyms used throughout this opinion is attached as an appendix.

[3]Treasury Regulation § 1.501(c)(3)-1(d)(l)(i) states that an organization may be exempt if its exclusive purpose is religious, charitable, scientific, testing for public safety, literary, educational or prevention of cruelty to children or animals.

ruling denying CST's bid for tax exemption. CST appealed that administrative decision to the court pursuant to I.R.C. § 7428(a), resulting in the instant case.

The IRS denied CST's application because the organization failed to establish that it was operated exclusively for exempt purposes. The IRS found that CST was operated for the benefit of the private interests of the founder of the religion of Scientology, L. Ron Hubbard, up until his death, and that subsequently it was operated for the substantial non-exempt purpose of aiding other Scientology organizations in their marketing of Scientology services and publications.

After consideration of the issues presented, and for the reasons that follow, the court concludes that the CST has not carried its burden of establishing that the Commissioner's decision was incorrect. It has not demonstrated that it is operated exclusively for tax-exempt purposes. The administrative record persuades the court that CST was founded for the primary purpose of gaining tax-exempt status to serve the financial goals of other, non-exempt entities, and that CST's archiving activities are secondary to its obtaining a tax exemption and would not of themselves qualify CST as a tax-exempt organization under I.R.C. § 501(c)(3).

I. FACTS

A. History and Tenets of Scientology

In 1950, L. Ron Hubbard ("LRH") founded the church of Scientology based of a new science he had created that he termed "Dianetics." The first Scientology church was incorporated in 1954. Since its founding, Scientology has grown and expanded into a complex hierarchy of related churches and organizations. Each entity has a specific place in the ecclesiastical scheme of Scientology as a whole. LRH died in 1986, but his writings and other recorded words are still considered to be scripture by adherents of Scientology.

Scientology is based on a belief that man is an immortal spirit who has lived through previous lifetimes. Plaintiff describes the goal of Scientology as "a civilization without insanity, without criminals and without war, where the able can prosper and honest beings can have rights, and where man is free to rise to greater heights." Defendant's Proposed Finding of Fact ("DPFF") 6.

Scientology hopes to achieve this goal through its sacrament of "auditing." Through this process the person or "preclear" is "cleared" of problems and behaviors caused by his "reactive mind." The reactive mind is the term used by Scientologists to describe a force that causes a person to act irrationally or against his own best interest. Scientology seeks to allow a person to overcome his unknowing obedience to the reactive mind, help him to clear himself of its influence, and make him responsible for his actions. When a person becomes clear, he achieves freedom from unwanted burdens, and becomes certain of immortality. The concept of immortality and previous lives is behind Scientologists' desire to preserve the words of LRH for billions of years.

Providing auditing services is the chief function of "Class IV" churches.[4] It is the responsibility of these churches to bring new members into Scientology, and to provide them with basic Scientology services. As a person moves along in the auditing process, he becomes eligible to receive services from the higher level churches. Higher level services must be provided by a church higher up in the hierarchy because they involve the "Advanced Technology" of Scientology. Plaintiff describes this as "[t]he portion of the Scientology scriptures that constitutes the upper levels of spiritual awareness in the Scientology faith." Plaintiffs Proposed Finding of Fact ("PPFF") 8. The Advanced Technology is what might be thought of as the revealed wisdom of Scientology. Access to it is heavily guarded

[4] *See* discussion *infra* p.5.

and is granted only to those parishioners who have completed a specified number of auditing courses and progressed to a certain level in Scientology training. Before one is allowed to access to Advanced Technology, one must agree not to share it with anyone still in the lower levels of Scientology.

All auditing services, of whatever level, must be purchased for cash by the recipient according to a scale of "fixed donations," or "fixed contributions." Scientology scriptures discuss the "Doctrine of Exchange" or the need to "balance inflow with outflow." Payment for auditing is explained as a requirement of this doctrine. Although characterized by taxpayers as a religious contribution, the Supreme Court has held that payments for Scientology auditing services do not generate a tax deduction for the individual taxpayer.[5]

Scientology scriptures also discuss at length the error of allowing the public to pay on credit, or of selling auditing for less than full price. In Hubbard Communications Office ("HCO") Policy Letter of April 27, 1965, LRH cautions, "The tendency then against which we must guard is covert lowering of prices once set."

B. Organization of Scientology Hierarchy

For reasons discussed below, the court concludes that the Commissioner properly viewed CST's petition in the context of Scientology as a whole. It is necessary, therefore, to describe that wider structure from an organizational standpoint.

Scientology has undergone almost constant corporate metamorphosis since its creation. In order to try to untangle the current structure and put it in proper perspective, we begin with the state of affairs prior to 1981, when the latest reorganization impetus arose. Before 1981, the Church of Scientology of California ("CSC") acted as the mother church for all of Scientology. It was organized as a non-profit corporation in Califor-

[5] *Hernandez v. Commissioner*, 490 U.S. 680 (1989).

nia, and was responsible for running all aspects of Scientology with the exception of some specialized financial arrangements. It had ultimate ecclesiastical authority, provided all levels of Scientology services, and was the center of management for all other Scientology organizations. CSC was founded in 1954 and was recognized, for a time, as tax-exempt by the IRS. The IRS issued a letter revoking the tax-exempt status of CSC in 1967. Thus began a lengthy investigation of CSC and other affiliated organizations. The IRS issued a notice of deficiency in 1977, CSC appealed this decision to the Tax Court and the matter was tried. Although the Tax Court did not issue its ruling until 1984, *Church of Scientology of California v. Commissioner*, 83 T.C. 381 (1984), *aff'd*, 823 F.2d 1310, (9th Cir. 1987), *and cert. denied*, 486 U.S. 1015 (1988), by 1981, CSC would certainly have realized that its tax-exempt status was in doubt.

In 1981, several high-ranking Scientology officials undertook a Mission Corporate Category Sort-out ("MCCS") to develop a new corporate structure for Scientology. The court does not know exactly what was discussed at the meetings although the meetings were recorded on audiotape. During the administrative process, the IRS requested on at least three occasions that CST produce the tapes. CST refused on the grounds that it did not have access to them, and that the tapes were in any case irrelevant to CST's tax-exempt status. The tapes had been put under a protective order by the Superior Court for the County for Los Angeles in a case involving CSC and a former Scientology employee.[6] The IRS issued a summons to the Clerk of the Los Angeles court to produce the tapes in connection with the investigation of CSC. CSC intervened in the suit asserting that the tapes were protected by the attorney-client privilege. The Ninth Circuit, which heard the case on appeal, reviewed the tapes and held that they contained evidence of intent to defraud the IRS, and thus were not protected by the

[6] *Church of Scientology of California v. Armstrong*, No. 420153, (Super. Ct. Los Angeles 1984).

attorney-client privilege.[7] This decision was issued during the present action. CST still did not produce the tapes claiming the MCCS discussions were abandoned in June of 1981, and that no action was taken with regard to anything the committee discussed.[8]

Nonetheless, shortly after the talks ended in 1981, Scientology underwent a reorganization. The goal of the new structure was for Scientology to "simplify its corporate structure.[9]

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[7] *United State v. Zolin*, 905 F.2d 1344 (9th Cir. 1990), *cert. denied*, *Church of Scientology v. United States*, 111 S. Ct. 1309 (1991).

[8] CST opposed the court's suggestion that the tapes be made part of the record here, but finally agreed, one month after oral argument, to make a transcript available to the court. Before CST would produce the transcript, however, the court had to agree that the transcript would be kept under seal, and further, that neither the transcript, nor any "commentary about it . . . [would] become part of the public record." The court declines the offer, but makes two observations about it. First, it shows that CST has access to the tapes. Second, if the court were to comment on the transcript in this opinion, the offer contemplates that this opinion itself would not be accessible to the public.

[9] After the church was "simplified," the record suggests that at least the following organizations constitute the church of Scientology: Founding Church of Scientology; Church of Scientology International; Religious Technology Center [including the Authorization, Verification and Correction Unit]; Church of Spiritual Technology; 129 Missions of Scientology, governed by Scientology Missions International; Church of Scientology Celebrity Centre International; 141 Class IV churches [local organizations such as the Church of Scientology of Portland or the Church of Scientology of San Francisco]; Continental Liaison Offices [known as CLOs]; Saint Hill Organizations; Church of Scientology Flag Service Organization; Flag Land Base; Flag Estates Org; Flag Command Bureaux [including Compilations Unit, LRH Artist, International Training School, New World Corps, Strategic Book Marketing Unit]; International Hubbard Ecclesiastic League of Pastors [known as HELP]; Sea Organization Officer Council; the American Saint Hill Organization; Advanced Organization Los Angeles; Golden Era Studios; Watchdog Committee; the Commodore's Messenger Organization International; the Executive Director International; the Senior Executive Strata; the International Network of Computer Organized Management;

CSC was broken up and replaced by several new higher-level entities. Church of Scientology International ("CSI"), Religious Technology Center ("RTC"), Church of Scientology San Francisco, and Church of Scientology Los Angeles were all products of the reorganization. CSI, RTC and CST, which was created in 1982,[10] are all what the court will refer to as "management churches."[11] The management churches collect money sent to them from the missions and Class IV churches. CSI became the new mother church of Scientology. It sits at the top of a complex corporate hierarchy. RTC is the entity charged with maintaining doctrinal purity in the church. CSI along with RTC form the top-level ecclesiastical management of Scientology, although there are numerous other churches and other entities that have a role in management, finance or spiritual affairs. The Church of Scientology Flag Service Organization, another of the management churches, delivers the highest level of Scientology services, training, and auditing. Ecclesiastical oversight is accomplished by CSI through the Watchdog Committee ("WDC"). This committee is responsible for oversight of the international ecclesiastical management structure of Scientology organizations.

World Institute of Scientology Enterprises; Golden Era Productions; Office of Special Affairs International; Bridge Publications; LRH Public Relations International; Household Unit; Inspector General Network [comprised of the Trademark Integrity Division and the Qualifications Division]; the United States Scientology Films Trust; International Scientology Films Trust; Author Services Inc., Cancorp, Religious Research Foundation; International Association of Scientologists; Church of Scientology Religious Trust.

[10] For a discussion of CST's place in Scientology hierarchy, see *infra* pp. 8-9.

[11] Scientology materials refer to the organizations which are in charge of ecclesiastical and administrative affairs as "Advanced Organizations" and explains that "Advanced Organizations deal in the upper level of [Operating Thetans]. They are staffed with Sea Org members. They have direct lines to Flag." L. Ron Hubbard, *Modern Management Technology Defined* 12 (1976).

The four Saint Hill[12] Organizations are the first step down from the management level churches in the Scientology hierarchy. They primarily train auditors. Next are the 141 Class IV Churches which deliver lower and intermediate level church services and are authorized to ordain ministers. Class IV churches are so called because the most advanced auditors there have progressed to Class IV of auditor training.[13] Class IV churches are subordinate to Continental Liaison Officers ("CLOs"). CLOs answers to the ecclesiastical authority of RTC and CSI.

The base of the church is formed by the Missions of Scientology, of which there are 129. These only provide the lower levels of Scientology services. Missions do not have the authority to ordain ministers. Scientology Missions have no ecclesiastical authority and are under the total control of Scientology Missions International.

The multiple layers of hierarchy thus create two different operational levels. The first is the management churches, which make all organizational decisions. The second is made up of Scientology Missions and Class IV churches, which deal with the public and deliver Scientology's religious services. It is this

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[12]Saint Hill was the name used for the English manor house purchased by LRH in 1959 which served as Scientology's headquarters. The Hubbard Communications Office was moved there in 1959 from its previous location in London. The office was the source of all Policy Letters issued by LRH. Policy letters, considered part of the Scientology scriptures, covered subjects ranging from proper management technique, to dealing with government agencies, to maintaining a sufficient level of income in all Scientology organizations. LRH also used Saint Hill as a place where those training to become Scientology organizations. LRH also used Saint Hill as a place where those training to become Scientology ministers could live while receiving training to become Scientology ministers could live while receiving training. LRH sold the Saint Hill facility to the Church of Scientology of California in 1966. *Church of Scientology of California v. Commissioner*, 83 T.C. 381, 494 (1984).

[13]The Class levels extend up to Class XII. L. Ron Hubbard, *Modern Management Technology Defined* 82 (1976).

second level which the public would perceive as the "church" of Scientology. It carries out the work and fulfills the spiritual purpose discussed in Scientology scriptures. With one exception, all of the 14 Scientology churches that have received tax-exempt status have been this type of local, Class IV church.[14] In contrast to the Class IV churches, these management churches and the original head church, CSC, have often had on-going conflicts with the IRS. Either their tax-exempt status has been revoked, or it has been denied in the first instance.

After carefully examining the record and attempting to understand the nominal corporate structure of Scientology it is apparent to the court that it is something of a *deceptis visus*. Real control is exercised less formally, but more tangibly, through an unincorporated association, the Sea Organization, more commonly referred to as the Sea Org. This group, in the nature of a fraternity or clan, began with Scientologists who pledged themselves eternally to Scientology and who accompanied LRH in his sea-going spiritual research in the Mediterranean. In 1967, LRH and other Scientology staff moved onto a yacht, the *Apollo*, "to pursue [LRH's] research of the upper levels of spiritual awareness." LRH and his *Apollo* staff performed Scientology services, managed the Scientology organization, and conducted

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[14]IRS Publication 78, Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code, is updated and published annually by the IRS. The List as revised to September 30, 1989, lists the Churches of Scientology for Boston, Florida, Hawaii, Michigan, Minnesota, Missouri, Nevada, New York, Portland (Oregon), Sacramento, Texas, Washington State, and Western United States (Los Angeles) as being exempt organizations to which people can make tax deductible contributions. The last named is apparently the successor organization to the Church of Scientology of San Diego, and is not a Class IV church but conducts the activities of The American Saint Hill Church Organization, the Advanced Organization Los Angeles, and the Continental Liaison Office. Appendix to Plaintiff's brief of October 15, 1990, p. 355. It is not clear to the court how these latter entities operate.

spiritual research. If LRH could have been compared to Achilles, members of the Sea Org would have been his Myrmidons.

The Sea Org appellation survives in Scientology as a distinction afforded to those Scientologists who have dedicated themselves to serving Scientology for the next billion years. It is described by CST as a way to distinguish Scientologists worthy of great deference and respect. Sea Org members are initiates into the highest levels of Scientology, and bear concomitant responsibilities.

CST staff and officers are required to be members of the Sea Org, which gives CST the distinction of being a Sea Org Church. CSI, RTC, the Flag Service Org (which employs over 900 Sea Org members), the Saint Hill Churches, in short, all high ranking organizations are sea Org Churches. Being a "Sea Org church" means that the church's function is important enough to Scientology to warrant the attention of a significant number of Sea Org members.

Sea Org rank nominally carries with it no ecclesiastical authority in the sense that Sea Org members still take orders from the ecclesiastical leaders of whichever Scientology organization they join. Upon closer analysis, however, this appears to be a distinction without a difference because in a Sea Org church the ecclesiastical authority necessarily resides in a Sea Org member.

Furthermore, the Sea Org appears to have considerable financial importance. HCO Policy Letter of 16 June 1969 instructs the Flag Banking Officer International[15] that his duties include "seeing Ships, Bases and Missions adhere to *Sea Org finance policy . . .*" (emphasis added). HCO Policy Letter of 20 April 1969 states that due to the "current advent of Sea Org expansion and the recent establishment of an AO-SH [Advanced Organizations-Saint Hill]," the following "firm policy," *inter alia*, is established:

[15]The Flag Banking Officer is a high-ranking official in the financial hierarchy of Scientology organizations.

> 3. Proposals relating to tax, leases, purchase or rental of buildings, long term financial commitments, major changes in the Sea Org financial set-up must be approved by the FBO INT and forwarded to the 2nd Deputy Guardian for Finance WW [World Wide] for final okay before such can be activated.
>
> . . . .
>
> 9. In the event of an FBO's failure to do his duty thereby bringing Sea Org monies to risk, the FBO INT has the authority to remove him/her from post. . . .

Sea Org members also exercise considerable control over Scientology money through SOR Management Services, Ltd.[16]

C. Testamentary Structure of LRH and the Genesis of CST

LRH died in January 1986. As part of his estate planning, he had made three gifts to the Scientology. The first two were *inter vivos*, and a third was testamentary. All three transfers were made, or in the case of the will, designated, in May 1982.

First, LRH gave use of the Advanced Technology and religious marks to RTC.[17] These Scientology religious marks include the terms "Dianetics," "Scientology" and Mr. Hubbard's name, initials and signature. RTC is charged with the duty to oversee lower-ranking churches to ensure they practice Scientology in an orthodox manner. RTC gave CSI a license to use the marks with any Scientology services sold by CSI on condition that CSI recognize RTC as the final word on matters of theological orthodoxy.[18] As required by Mr.

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[16] *See* discussion *infra* p. 14, n.23.

[17] The Scientology Marks are trademarks which appear on all Scientology materials, and serve as guarantee of orthodoxy. The Advanced Technology is the advanced scriptures, literature and materials of Scientology.

[18] Scientology services are required to be orthodox. This maens that they must be provided under the "imprimatur of certain marks associated with the religion," PPFF 9. Although orthodoxy is not clearly defined in the record,

Hubbard's gifts, RTC delegates rights to use the Advanced Technology and religious marks to qualified churches in the ecclesiastical hierarchy and then supervises their activities to ensure compliance with Scriptural requirements. In exchange for use of the marks, churches that minister the Advanced Technology pay RTC six percent of the contributions they receive.

LRH's gift to RTC was conditioned on RTC obtaining exemption under I.R.C. § 501(c)(3). Thus far, RTC has been found non-exempt by the Commissioner.

CST was created in 1982 in order to receive the second gift. LRH gave CST two options over the marks and technology which he had given to RTC. The first option is to take control of the trademarks on published LRH works and the insignia of various organizations. The second option is over the Advanced Technology. CST has the option, exercisable at its sole discretion, to take over use and authority of the marks from RTC if RTC allows their use in an unorthodox manner.

The third gift was designated in LRH's will of 1982. In it, CST was made the conditional beneficiary of the remainder interest of LRH's personal estate, after certain bequests to family members. The CST bequest included the copyrights to LRH's Scientology works, and certain limited rights over the marks and technology that he had retained at the time of his gift to RTC.[19] It also included all of LRH's non-Scientology works of fiction which continue to produce royalties. The publishing rights and copyrights alone carry with them the rights to receive the

the court notes it has at least the result of requiring all churches to buy materials licensed through CSI, the current mother church. *See* discussion *infra* at pp. 14-16. All of LRH's works are copyrighted with formal licensing arrangements made between LRH and the distributing churches.

[19]The following copyrighted materials were included in LRH's bequest to CST: a) HCO Policy Letters; b) HCO Bulletins; c) Miscellaneous directives and orders concerning ecclesiastical matters; d) Tapes of lectures on Scientology and the rendering of Scientology services; e) Instructional films on Scientology.

substantial royalties which flow from sales of Scientology books and tapes to the public. These rights will provide CST with a sizable annual income, but only if it achieves tax-exempt status. These assets have not yet been distributed to CST, and they are accumulating income as part of the residual estate, which is being held by a pour-over trust.

D. Creation of the Church of Spiritual Technology

As part of LRH's estate planning, CST was founded in 1982 by Lyman Spurlock, Meade Emory, Esq., Leon Misterek, Esq., and Sherman Lenske, Esq., CST was incorporated as a non-profit corporation under California law, and subsequently sought tax-exempt status under the Internal Revenue Code.

CST's Articles of Incorporation describe the purpose of the organization as follows: "The corporation shall espouse, present, propagate, practice, ensure and maintain the purity and integrity of the religion of Scientology . . . ." Article III, By-laws of Church of Spiritual Technology.

One of CST's specific duties, unique among Scientology churches, is to create and maintain an archive of scriptures for future generations. It is important to Scientology that its scriptures be preserved for at least the next billion years, in order that future generations have available to them the words of LRH.

The other stated purpose behind CST was to provide LRH, then still living, with a depository for the bulk of his testamentary estate, as explained above. CST's founders wanted to accomplish "[t]he creation of an organization to which Mr. Hubbard would be willing to (and did) bequeath the bulk of his estate, and most importantly his copyrights and patents (which include copyrights to scriptures of the religion and patents on the E-Meter)."[20]

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[20]Letter from Lyman Spurlock, President of CST to IRS of September 10, 1984, at 5. The E-Meter, as described by LRH, is "[a]n electronic instrument for measuring mental state and change of state in individuals, as an aid to precision and speed in auditing." L. Ron Hubbard, *Understanding the E-Meter* 104 (1982).

CST's operating funds thus far have come exclusively from other Scientology management churches. In 1983, CST received what was described as a "one-time start-up grant" of $17,959,745 from the Church of Scientology Flag Service Organization. In addition, CST has received annual unrestricted grants from RTC ranging from $623,000 to 2.8 million.

None of the founders of CST, with the exception of Mr. Spurlock, has any stated religious connection to Scientology. Messrs. Emory, Misterek and Lenske have served as counsel to other Scientology groups, but nothing in the record indicates that any of them has ever been a member of any Scientology organization. Mr. Lenske and two other non-Scientologists have the status of Special Directors of CST. The Articles of Incorporation require that CST have three such Special Directors, and further requires that they be lawyers in order to ensure that CST takes no action to jeopardize its tax exempt status.

The General Directors and staff of CST are, however, closely linked to other Scientology organizations. The General Directors (the governing body) must be in good standing with the mother church. Staff members are required to have been Scientologists for at least eight years, and must be highly trained in the teachings and technology of Scientology. CST trustees are also required to remain actively involved in giving and receiving Scientology services. They must also participate in at least twelve and one half hours of training per week.

Many of the staff have held positions of authority in other Scientology organizations. Three of the four trustees of CST worked previously for CSC, which was dismantled in 1981. Terri Gamboa is a trustee of CST. She was also at the same time a Director, the President, and a shareholder of Author Services, Inc. ("ASI"), a Scientology organization. She had formerly been an employee of CSC and of LRH personally. Gregory Wilhere, a trustee of CST, was also formerly an employee of the Founding Church of Scientology, CSC, the Church of Scientol-

ogy Flag Service Organization and an Australian Scientology organization.

Marion Meisler is a trustee of CST. She was at the same time an employee of ASI, and had previously been employed by CSC, a United Kingdom Scientology organization, and an Australian Scientology organization. Lyman Spurlock is the President of CST, one of its directors, and one of its Trustees. He is also a trustee of RTC. As trustee, Spurlock has authority to elect and remove the directors who run RTC. Thus, Spurlock has the ability to influence RTC's activities. Spurlock was given a general power of attorney by LRH on March 12, 1984, as his personal employee. Dan Przybylski is Vice President of CST and one of its Directors. He has been an employee of CSC, CSI, and RTC. Leo Johnson is Secretary of CST. Previously he had been an employee of CSC. Nancy O'Meara is the Treasurer of CST. She had been successively employed by various Scientology organizations.

E. Activities of the Church of Spiritual Technology

CST is in the process of creating an archive of Scientology scriptures. These consist of the written and spoken word of LRH, as well as films concerning religious training and the administration of Scientology services. In pursuing this goal, CST has outlined its ambitious program of research into archival methods and technology. The purpose of the archive is to ensure that Scientology scriptures are available for billions of years. CST has thus been motivated to research long-term storage and preservation methods and to try to develop new technologies.

In order to complete its archiving mission, CST has purchased several large parcels of land. The organization's administrative offices and main preservation facility are in San Bernardino, California. The existing buildings at the San Bernardino facility were in serious disrepair when purchased. CST was required to pay large sums of money to repair enough of the buildings to house the resident staff. A number of the buildings

remain in need of extensive renovations. The 6,000 square foot preservation building was fitted with multiple layers of sheet rock in the ceiling and floor and also with two-hour fire doors to provide a storage space safe from fire. Another storage facility will be built in San Bernardino to house original Scientology scriptures.

CST has purchased other sites for storage facilities. On these it has built or intends to build vaults with specially constructed doors. Currently, CST owns archive sites in Northern California and New Mexico and has plans to acquire additional sites. The site in New Mexico was purchased for $250,976. The Northern California site cost $1.5 million. Vault construction in New Mexico was begun in 1986 after the construction of staff living quarters, access roads, and water supply. CST also reinforced the face of the site, installed a hoist, and built a work pad, all of which cost $260,000. Other construction costs have included $90,000 to overcome rock fissure impediments encountered in the drilling of the underground tunnels in New Mexico, and $120,000 for maintenance-free doors to be placed at the mouths of the tunnels. Vault construction at San Bernardino and Northern California is predicted to cost over $5 million.

To accomplish its archiving mission, CST employs a staff of from 15 to 63 "highly dedicated" Scientologists who are under the control of CST management. All CST staff members must be trained in Scientology. They live at the preservation site, are paid a subsistence wage, and are required to improve continually their knowledge of Scientology and its teachings. They must spend a specified minimum amount of time each day in Scientology training and teaching pursuits.

CST intends to preserve Scientology scriptures in all of the forms in which they currently exist. Among the technologies that CST is trying to adapt or develop for this purpose are microfilm, color separation for film tape, durable paper and ink for the production of durable masters, digital audio recording,

gold and glass laser discs, respooling equipment, soundscriber discs, environmental conditions with respect to creating better storage conditions for archived materials, archival xerography, binding, deacidification of paper used to preserve all written originals, encapsulation in mylar plastics, time capsules filled with inert gas, and construction of vault doors built to be maintenance-free for at least 1,000 years. Because it cannot find equipment and technology that meet its standards, CST has become active in developing new preservation techniques. CST is also involved in developing new E-Meter technology.

The stages of archiving are elaborate. First, CST must obtain the original Scientology work. Originals have been found in the possession of individuals in many different countries. In most cases, the possessors of the documents have donated them to CST for preservation. CST also obtains originals from RTC. CST makes seven copies of each original; two copies on microfilm, and five on acid-free paper. The microfilm copies reportedly have a lifespan of at least 100 years, while CST expects the paper copies to last 1,000 years. These de-acidified paper copies are known as "durable masters." The original is then encapsulated in mylar and placed in a gas-filled time capsule. Some of the durable masters are placed in fire-proof containers and kept in one of the storage facilities, others are kept available for study purposes.

CST also has begun the process of collecting Scientology films written or directed by LRH. In order to preserve them for a longer period of time, CST plans to process the color out of the film. CST has begun the process of restoring some of the original films. When all of the original films have been obtained, CST intends to make copies to store in each of the planned storage facilities. CST predicts that keeping, storing, copying, and processing the films will be a costly undertaking. Particularly with respect to the color-removal process, CST believes archiving the films will cost $350,000 for the equip-

ment to perform the color-removal process, and $150,000 actually to remove the color from each of the 42 films. To have this work done by an outside professional laboratory would cost over $1,000,000.

CST's archiving activities will include preservation of audio tapes of lectures given by LRH. There are reportedly over 6,500 master reels of original recordings to be copied and preserved. Some of the earlier lectures exist on small "Soundscriber" discs which apparently are a challenging medium to preserve. CST has completed the process of making seven magnetic tape copies of each of the master tapes. This has cost $1.3 million dollars in tape and equipment costs. Of these seven copies, four are archival quality reel to reel tapes destined for storage in the underground storage centers. Two are to be kept for research purposes, and one, of non-archival quality, is to be provided to CSI. CSI will then prepare a transcript of the tapes which it will furnish to CST.

Since magnetic tape cannot be preserved as long as CST would like, it has been investigating other media such as digital sound technology. CST now plans to convert its analog magnetic tape recordings into digital signals which it will then transfer onto special video tape. CST intends to make video tapes of each of the 6,500 master tapes that constitute the library of LRH recorded lectures. This project is expected to cost $200,000. The production of these video tapes will not add to the life of the recorded words, however. Thus, CST eventually plans to transfer the video tapes onto laser discs. Gold-plated glass discs currently seem to have the longest life of all materials, but a full set of such discs would cost more than $6 million, which CST considers excessive.

F. Financial Structure of Scientology

CST states that it does not participate in any of the hierarchical church's financial accounts. In a literal sense this may be true. However, given the fact that CST currently gets all its

operating funds from other Scientology churches, that courts have found commercialism and financial inurement throughout Scientology, and given the close links to other Scientology organizations forged by the LRH will and by overlapping personnel, the overall finances of Scientology are highly relevant to CST's application.

Procedures for handling money in Scientology are remarkably complex. Income is generated chiefly by the Class IV churches and by the Missions, although income is also generated by the higher level churches. All Scientology services or "auditing" must be paid for, thus the Class IV churches and missions take in a considerable amount of money from individuals and independent ministers who purchase books, auditing services, and E-Meters from the local church or mission. Payments are made by the lower churches to CSI for ecclesiastical services, and as noted below, all lower level churches are expected to contribute to Central Reserves.

According to CST, each local church keeps several bank accounts, but all money initially is deposited into the "FBO" No. 1 Account. From that account, money can be placed into at least one of nine accounts. These include accounts for money to be paid to parishioners as a reward for completing a specified course of study, for refunding the fixed donation of a parishioner who is not satisfied with the materials or auditing services, and monies held "in reserve" in accordance with Scientology policy to be used for local purposes. In addition, each church keeps a separate account from which to pay its Field Staff Members' commissions and to cover the local expenses of higher level churches. Finally, each church keeps an account for miscellaneous expenditures that do not fall into any of the previous categories. In addition, some disbursements, such as the required payments to the United States Scientology Films Trust are made directly from FBO No. 1. These are license payments for the films provided to the local churches by the Films Trust.

The court notes that earlier policy letters refer to the requirement adopted in 1965 that all Scientology organizations create "Reserved Payment Accounts." These serve as temporary repositories for monies that may be disbursed to general creditors. Instructions associated with operation of these accounts make it clear that LRH discouraged prompt payment of bills, a policy he referred to as dateline paying. HCO Policy Letters of March 4, 1965 and March 28, 1965. "We aren't interested in bills as bills. We're interested in 'all bills earlier than a certain date.'" HCO Policy Letter of 28 January, 1965. LRH instructs accounts personnel to take the following approach with tradesmen demanding full payment: "Just say to tradesmen who dun you, 'Oh, really? We'll send you a cheque.' Never say how much." HCO Policy Letter of 28 March, 1965.

Some Scientology corporations are made up of more than one church organization. For example, the Church of Scientology Western United States is made up of the American Saint Hill Organization, the Advanced Organization of Los Angeles, the Continental Liaison Office for the Western United States, and its Estates Org which maintains the physical plant of the Western United States church. Where this is the case, the smaller organizations maintain each of the above accounts independently from the others. There are sometimes transfers between the parallel accounts of the different churches.

Before it can spend any of its money, each of the 141 local churches is required to submit a weekly proposed Financial Planning ("FP") report, which is the proposed budget for the church for that week. The report must be negotiated and approved by two committees composed of church executives (the Advisory Council and the Executive Counsel) both of which have line item veto power. The FP report is further subject to final approval of the local Flag Banking Officer ("FBO").

The FBO is charged with maintaining the financial prosperity and expansion of the church. The FBO prepares the

FBO Weekly Report which contains the allocations a church has made to each of its bank accounts, as well as any amount the church will contribute to Central Reserves to benefit Scientology as a whole. The FBO has a high level of ecclesiastical authority with which he or she ensures that all money is allocated and spent properly. The FBO is, in turn, ruled by the local Finance Enforcement Officer ("FEO"), who has higher ecclesiastical rank.[21]

1. The Central Reserves

Each local church, mission, and higher level church is required to contribute to the Central Reserves of Scientology.[22] These play an important part in the structure of Scientology finances. Central Reserves are kept in accounts called, variously, central accounts, central bank accounts, SOR accounts or central reserve accounts. The actual money in the account, as distinct from the account itself, is identified as Sea Org reserves, SO reserves, or SOR.[23] The Central Reserves are the responsibility of the individual holding the office of WDC Reserves. The WDC Reserves is a high-ranking member of the Watchdog Committee, and also a member of the Sea Org.[24] The WDC Reserves' immediate juniors are the International Finance Director and the Flag Finance Director. All three of these officers are employed by CSI, and are Sea Org members.

[21]FBOs and FEOs are themselves subject to the authority of their respective networks. The FBO Network is comprised of staff members of the Continental Liaison Office. The FEO Network is comprised of Continental Finance Ethics Officers, staff members of the Continental Liaison Offices. These officers are in turn supervised by the Flag Finance Ethics Officer, who is an employee of CSI.

[22]CST apparently maintains its own Central Reserve account.

[23]This money is managed by Sea Org members through SOR Management Services, Ltd., a for-profit corporation in the Untied Kingdom, which acts as an agent for U.S. churches and trusts which hold Central Reserve Accounts: CSI, CSFSO, CSC and the Churches of Scientology of New York, Boston, Las Vegas, and Portland.

[24]See discussion *supra* at 6-7.

The total amount of central reserves held by Scientology at any given time is difficult to calculate. There are the several Central Reserve accounts maintained by different management-level churches. In addition, there is the account into which the local churches pay their share of the reserves managed by WDC Reserves. In addition, all of the trusts formed by Scientology are considered part of Central Reserves. The Central Reserve account may also carry loans made by it to any of the local churches who may have needed to borrow money following, for example, a drop in auditing sales. Money reported as previously spent out of Central Reserves conservatively totals over $94 million.

2. Scientology Trusts

In addition to its many bank accounts, Scientology stores money in at least ten separate trusts. These trusts are considered part of the church's central reserve, and include the International SOR Trust, International Publications Trust, SOR Management Services, the Church of Scientology Religious Trust, the Scientology Endowment Trust, the Church of Scientology Expansion Trust, the Buildings Trust, the Dissemination Trust, the International Missions Trust, and the Films Trust. The trusts own and/or control publication and distribution channels for religious books and products, and provide investment and financial management services. Some of them have been granted tax-exempt status by the IRS as religious trusts. Each of them has a specific place in the financial organization of the church and is supervised directly by its own Board of Trustees. As part of the central reserve system, the trusts are also subject to the ecclesiastical supervision of CSI. CSI ensures that trust monies are spent in accordance with orthodox Scientology policy.

3. Bridge Publications

Bridge Publications, Inc. ('BPI') is:

. . . a California for profit corporation. BPI publishes and distributes the Scientology Scriptures (including books and recorded tapes), manufactures, repairs and distributes E-Meters, and publishes and distributes fiction works written by L. Ron Hubbard.

Sea Org members hold all of the upper level management positions in BPI, and many of its employees are Sea Org members. BPI is organized and operates (to the extent consistent with its status as a for profit business corporation) in accordance with the Scriptures.

Prior to the incorporation of BPI in 1981, the publication and distribution of the Scriptures and the manufacture and distribution of E-Meters in the United States were activities of Church of Scientology of California. Upon incorporation of BPI, Church of Scientology of California (CSC) transferred the assets used in those activities to BPI in exchange for all of its capital stock. In 1982, CSC sold all of the shares of BPI to International SOR Trust, a non-U.S. religious trust. In 1985, International SOR Trust transferred the shares of BPI to International Publications Trust (IPT), which continues to own all of the shares.

IPT is a Scientology religious trust governed by three trustees. . . . . Two of the trustees of IPT are non-resident aliens. The third is a United States citizen and resident and a staff member of CSI, holding the position of WDC Pubs, i.e., the member of the Watchdog Committee concerned with ecclesiastical matters relating to the publication, manufacture, distribution and sale of the Scriptures and of the E-meters.

> In addition to the shares of BPI, IPT owns all of the capital shares of a for profit holding company (a United Kingdom corporation) which in turn owns all of the capital shares of New Era Publications (NEP), the Danish for-profit publisher which publishes and distributes the Scriptures outside the United States. NEP is managed and primarily staffed by Sea Org members.
>
> BPI has the right to publish the Scriptures and to manufacture E-Meters pursuant to agreements with NEP. NEP in turn has the right to produce these items and to license their production pursuant to agreements entered into with L. Ron Hubbard. Under these agreements, BPI pays royalties to NEP with respect to the copyrighted and patented articles, and NEP in turn pays royalties to Mr. Hubbard and his successors in interest, with respect to royalties received from BPI and with respect to items published directly by NEP.

P. App. pp. 376-77. Thus BPI is ultimately controlled by three trustees, one of whom is a CSI staffer, the WDC Pubs. The WDC, a function of CSI, in turn is more generally responsible for "oversee[ing] the entire international ecclesiastical management structure of the Church," including publication activities of BPI and NEP. P App. pp. 336-38, 375-80. BPI and NEP hold the requisite licenses to sell Scientology materials, and any payment made to BPI or NEP eventually devolves to the financial benefit of "Mr. Hubbard and his successors," which includes RTC and CST. Furthermore, all religious materials must be orthodox, and only materials licensed by CSI are orthodox. Although it is apparently the pour-over trust that currently receives royalties from the publication rights, it is CST that, under the will, stands to move into the position of ownership of those rights.

Thus, CST not only is positioned to support BPI's for-profit activities by furnishing authentic copies of archived materials,[25] it stands to receive royalties from the for-profit publishing companies, and, if it exercises its options over RTC, will received royalties from use of the advanced technology. As to the supplying of Scientology services, in view of CSI's receipt from RTC of the license to use the trademarks, it would appear to have stepped into Mr. Hubbard's shoes to the extent of receiving payments for use of the marks. Presumably if CST exercises its option over RTC, it would be able to control those marks as well, thereby completing its ownership of the publishing rights, the advanced technology, and the marks.

4. The Doctrine of Exchange

During the administrative process, the IRS questioned CST regarding the doctrine of exchange. The doctrine of exchange requires that in order to receive, it is also necessary to give. A Scientologist is obligated to exchange something he values for anything he acquires. Thus, he must exchange cash for auditing services. He must exchange cash for Scientology books. He must exchange any original LRH documents he possesses for

[25]CST has two roles with respect to films and tapes as well. Under LRH's will, CST stands to take ownership of those assets. It is also responsible for archiving such materials. Nevertheless, until CST's rights are clarified, BPI and CSI will be involved with the receipt of proceeds from the production and distribution of films and tapes. LRH licensed his copyrights in the films to CSC in 1982 for distribution in the Untied States. Outside-the-United States distribution was to be done by an entity designated by LRH. Golden Era Studios was set up by CSC to reproduce audio tapes and to produce motion pictures. CST represented to the Commissioner that "in 1985, CSC sold the assets of Gold to CSI, and since then all activities of Gold have been conducted by CSI." The United States Scientology Films Trust was crated to distribute the films to churches in the United States, "to receive license fees from them, to pay over to CSC its costs of production and thereafter to retain and expend the amounts received from the churches for religious purposes." After having paid for the films, the trust has collected "in excess of $3 million." As to tapes, BPI "is licensed to copy the tapes," presumably under a prior arrangement with LRH.

the satisfaction of advancing the Scientology cause. The doctrine was described as a fundamental belief of the religion, yet at other times, CST insists it is a minor part of Scientology. It has, however, consistently been cited as the explanation for why all Scientology religious services must be paid for by those receiving them. CST explains the doctrine as being based on early writings of LRH which discuss the importance of balancing inflow of money or services, for example, with outflow.

G. Prior Litigation Involving Scientology

The instant litigation is not the first time a Scientology organization has been in court. At the administrative level, the Government relied in part on findings made by other courts in earlier litigation involving Scientology churches. CST opposed making such use of prior litigation, arguing that it occurred largely before CST even existed.

To the extent findings or conclusions in other cases are inconsistent with the record developed exclusively for CST, the record here controls. The court will, nevertheless, consider non-conflicting evidence introduced into the record from other litigation, and will take judicial notice of reported opinions dealing with Scientology organizations.[26] The court finds below that CST is inextricably linked to Scientology as a whole. It would have been naive for the Commissioner, and it would be equally naive for the court, to ignore the implications of the genesis of CST and its links to other Scientology organizations.

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[26] *See United States v. Estep*, 760 F.2d 1060, 1063 (10th Cir. 1985); *see also E.I. Du Pont De Nemours & Co. v. Cullen*, 791 F.2d 5, 7 (1st Cir. 1986) (court took notice of complaint filed in state court proceeding which dealt specifically with matters at issue in federal proceeding and where neither party disputed document's authenticity.); *St. Louis Baptist Temple, Inc. v. FDIC*, 605 F.2d 1169, 1172 (10th Cir. 1979) (federal court may take notice of proceedings in other courts which have a direct relationship to matters at issue). *See generally*, IX Wigmore on Evidence §§ 2578-2579 (Chadbourn rev. 1981).

Courts that have examined the affairs of the other Scientology management churches have been persuaded that the way in which Scientology operates is often indistinguishable from any commercial activity, and that church resources have been used for private benefit. In *Church of Scientology of California v. Commissioner*, 83 T.C. 381 (1984) ("*CSC*"), the court held that the Church of Scientology of California was no longer being operated in accordance with I.R.C. § 501(c)(3) and therefore the IRS was entitled to revoke its tax-exempt status. The court in *CSC* found substantial evidence of private inurement to LRH and his family, including salaries, management fees, complete support of LRH's family, and royalty payments on LRH's writings. *CSC*, 83 T.C. at 492. Additionally, the *CSC* court found "covert indicia of benefit" to LRH including repayment of unspecified debts, and LRH's absolute control over the millions of dollars resting in operation Transport Corporation, Ltd.[27] and the United States Churches of Scientology Trust. *Id.*

The court in *CSC* also found that the church had failed to carry its burden of proving that it was organized and operated exclusively for exempt purposes, and had failed to produce financial information, or had denied the IRS access to many financial records. The documents it did provide were turned over in a confused, disorderly fashion with no index and no assistance or explanation of what was contained in them. This lack of cooperation, on which the court remarked throughout the opinion, led it to hold that it could draw negative inferences from the evidence not produced. "The failure of a party to produce relevant evidence within its possession or control gives rise to the presumption that, if produced, it would be unfavorable." *CSC*, 83 T.C. at 502 (citations omitted). Based on the lack of information provided, the court found the Untied States Chur-

[27]Operation Transport Corporation, Ltd. ("OTC"), is a non-charitable Panamanian corporation, found by the court in *CSC* to be run by the Flag Banking Organization ("FBO"). *CSC*, 83 T.C. at 387. OTC was found to be a sham corporation for which FBO created financial records to give the false impression of a legitimate, independent existence. *Id.* at 505.

ches of Scientology Trust and the Operation Transport Corporation were run for the private benefit of LRH and his family. *CSC*, 83 T.C. at 500. The *CSC* court further found that the church of Scientology was operated for the substantial commercial purposes of tax evasion, making money, and criminally manipulating the IRS as a method of financial planning. *Id.* at 504.

In litigation, Scientologists continually have accused the IRS of singling them out for a unique kind of religious persecution. In *CSC*, the court examined the history of IRS actions against various Scientology churches and found that Scientology organizations have indeed been frequently investigated by the IRS. Many of the investigations were lengthy and far-reaching. The IRS expounded special instructions in a "Manual Supplement" issued to its investigators and attorneys specifically regarding the treatment of Scientology churches. Upon specific examination of the IRS's behavior in *CSC*, the court found no support for the Scientologists' claims of harassment. It found instead that the IRS had in fact been deliberate in its investigation of CSC, and had followed the same procedures used in investigations of other churches. The court also found that the Scientology churches' own behavior had more than justified the IRS's attention. *CSC*, 83 T.C. at 453.

Litigation involving Scientology organizations has often been protracted and combative. For example, even though the IRS revoked CSC's tax-exempt status in 1967, CSC continued to file informational Form 990's and no other forms, even though it had been told to begin filing annual returns.[28] *CSC*, 83 T.C. at 382, 405. CSC ignored the IRS revocation, which it claimed it was entitled to do, since its tax-exempt status had been improperly revoked and was thus ineffective.[29]

[28]Form 990 is a form filed by non-profit organizations.

[29]The proper procedure, of which CSC had been notified by the IRS, would have been for CSC to have filed the forms appropriate for an organization no longer exempt, pay the tax then assessed, and then apply for a refund.

In *Founding Church of Scientology v. United States*, 188 Ct. Cl. 490, 412 F.2d 1197 (1969), *cert. denied*, 397 U.S. 1009 (1970), members of the Founding Church of Scientology filed a refund suit. Plaintiffs claimed that they were a religious organization under I.R.C. 501(c)(3), and therefore were entitled to have money previously paid in taxes refunded to them. The Court of Claims denied the claim. The court found that some of Founding Church's money inured to the individual benefit of LRH, his wife and son. This included a house maintained by the church, a percentage of the church's income, and other royalties and commissions. The court based its finding of inurement on informal loans made to LRH that were never sufficiently explained or documented.

In *Founding Church of Scientology, Inc. v. Webster*, 802 F.2d 1448 (1986), *cert. denied*, 484 U.S. 871 (1987), the plaintiff initiated a suit against William Webster, Director of the FBI. Founding Church members alleged that the FBI was harassing Scientologists for no permissible reason. The district court dismissed the litigation after the Founding Church of Scientology defied a court order to produce LRH for deposition. The case came to a standstill at the church's continued refusal to cooperate with a request to produce LRH for a deposition. The church took the position that LRH was no longer a "managing agent" of the church and therefore was not a party to the litigation. The FBI had submitted prima facie evidence that LRH was still a managing agent of the Founding Church and should appear for deposition. The Founding Church merely repeated its assertion that LRH was not a managing agent, and that in fact he had severed nearly all contact with the church management. The district court ordered the Founding Church to produce LRH for the limited purpose of countering the FBI's prima facie evidence. The court found that despite LRH's

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I.R.C. § 601(a); *CSC*, 83 T.C. at 404. The right of CSC to pursue an administrative review of the revocation does not change the fact that revocation letters are effective upon their issuance. Treas. Reg. 601.201(n)(6).

formal resignation from all management positions in Scientology, in fact he maintained control of Scientology's finances and policies through his position in the Sea Org and other covert means. "Ultimate control, we have no doubt, he possessed until his death." *Webster*, 802 F.2d at 1456. After eight years of pre-trial discovery, the district court dismissed the case.

In affirming, the circuit court noted that the Founding Church filed its complaint in the same year (1978) in which Mary Sue Hubbard and eight other high-ranking officials of the church admitted in a plea agreement that "the network of Scientology organizations had conducted a broad campaign against U.S. Government entities, particularly the Internal Revenue Service." *Webster*, 802 F.2d at 1450. In fact, the *Webster* court noted that the same government investigations the Founding Church complained about were justified by, and a result of, the church's own illegal behavior. *Webster*, 802 F.2d at 1450 n.3.

In *United States v. Zolin*, 905 F.2d 1344 (9th Cir. 1990), *cert. denied, Church of Scientology v. United States*, 111 S. Ct. 1309 (1991), the Ninth Circuit found that the tapes of the MCCS conference, held in 1981, reveal that "[t]he figures involved in MCCS admit on the tapes that they are attempting to confuse and defraud the government." *Zolin*, 905 F.2d at 1345. The tapes were therefore not protected by the attorney-client privilege because they fell within the crime-fraud exception to the privilege.

H. Proceedings Before the Commissioner

The administrative process in this case began in 1983, when CST filed its initial petition for tax-exempt status. The process occupied nearly five years, ending on July 8, 1988, when the IRS issued its final adverse ruling. In the process, the parties put together one of the largest tax records ever accumulated. The Government complains, however, that on numerous occasions critical inquiries went unanswered, and that, despite its heft, the record is light on explanations. The court's examina-

tion of the record supports the Government's critique. Although CST frequently inundated the IRS with material, numerous key points were not candidly addressed. CST responded to some of the IRS's questions, but it refused to respond to others, claiming it did not understand the question, or chose merely to refer to previous responses.

CST, CSI, and RTC all applied for tax-exempt status at the same time. The IRS requested information about the circumstances surrounding the founding of these three organizations. The IRS specifically asked who initiated and oversaw the reorganization of the Scientology hierarchy. The IRS also enumerated the connections it saw among the three applicants and the existing Scientology hierarchy and asked for comment. The IRS did not say it would never consider CST's application separately, only that until the apparent connections were explained, it could not. CST continually refused to answer these questions, demanding that the IRS treat CST's application independently of RTC and CSI. At one point, CST informed the IRS that "it did not agree" that the IRS could not rule on CST's application without information about other Scientology organizations. In that same letter, rather than provide information to explain why the IRS's reservations about CST's tax-exempt status were groundless, CST simply stated that it rejected assertions made by the IRS, and that the reservations were insignificant anyway.

When pressed for additional information on its relationship to other Scientology organizations, CST merely repeated its initial inadequate answer that it did not voluntarily recognize the hierarchical church. The IRS found that answer inadequate, and asked the question again. CST gave a similar answer: "This assertion implies that [CST] is a part of the Scientology hierarchy. It is not. See our letter to you dated 10 September 1984."[30]

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[30]Letter from CST to IRS of November 7, 1984.

Rather than offer an explanation of the option agreements it held under LRH's gift, CST stated instead, "We do not consider [the options] to be as you characterize them. However, the agreements speak for themselves."[31] On another occasion, CST refused to respond to allegations in affidavits from former church members that the MCCS conference was tasked with devising a new structure which would mask LRH's actual control of Scientology and make it appear that he no longer took an active role in running the church. CST replied that the IRS "had no business" relying on information from such people.

On April 22, the IRS again wrote to CST for additional information. CST's response contained nothing new. For example, the IRS inquired about Sherman Lenske. Stephen Lenske and Lawrence Heller and their role as CST's "special directors." Instead of providing a meaningful answer to the question, CST replied, "We commented upon your position in our earlier correspondence . . . [w]e request that you inform us of the relevance of their other associations to the exempt status of this organization."[32]

The final stage of the administrative process began in March 1988. The IRS sent agents to CST's headquarters to conduct an on-site review of the organization's financial activities and operations. CST had agreed to allow the investigation. The process came to an end in June 1988 when, according to the IRS, CST refused to cooperate with the agents' requests for records. CST denies that it refused to cooperate, but agrees that it sent a letter in protest to the IRS on June 24, 1988, because an IRS agent had interviewed Vicki Aznaran, formerly the Inspector General of RTC,[33] without first informing anyone from CST. Although CST vehemently protests that it did not refuse to cooperate further with the on-site review, the June 24,

[31]Letter from CST to IRS of September 10, 1984.

[32]Letter from CST to IRS of June 26, 1985.

[33]The post of Inspector General of RTC is described by CST as "the highest ecclesiastical position within RTC." [P App. p. 361]

1988 letter states, "With that, we informed Mr. Joseph that the Applicants were suspending the review until we resolved the matter with the National [IRS] Office."[34]

Following the issue of a Final Adverse Ruling letter on July 8, 1988, counsel for CST sent several letters to the IRS attempting to continue the administrative process and challenging the IRS's position that it had been uncooperative. The IRS did not re-open the record, and the Final Adverse Ruling remained as issued. CST brought the instant action to challenge that ruling.

II. DISCUSSION

Income tax exemptions must be strictly construed, with any doubts to be resolved in favor of the taxing entity. *Harding Hospital, Inc. v. United States*, 505 F.2d 1068, 1071 (6th Cir. 1974). Consequently, determinations of the Commissioner are presumed correct. *Welch v. Helvering*, 290 U.S. 111, 115 (1933). To the extent that the Government relies on the grounds stated in the Commissioner's final decision, plaintiff thus bears the burden of proving its entitlement to an exemption. *Bubbling Well Church of Universal Love, Inc. v. Commissioner*, 670 F.2d 104, 106 (9th Cir. 1981); *Freedom Church of Revelation v. United States*, 588 F. Supp. 693, 696 (D.D.C. 1984). The court's review is based on the record below. *Church of Spiritual Technology v. United States*, 18 Cl. Ct. 247, 249 (1989). We accept as true statements in the record made by CST that were not challenged by the IRS. This does not obligate the court otherwise to accept conclusory statements contradicted elsewhere in the record.[35]

In order to qualify as a tax-exempt organization under I.R.C. § 501(c)(3), CST must prove that it is both organized and

[34]Despite CST's objections, the IRS agents were well within the law in contacting Ms. Aznaran. The IRS is authorized to contact any person and take testimony from that person "as may be relevant or material." I.R.C. § 7602(a).

[35]*World Family Corp. v. Commissioner*, 81 T.C. 958, 965 (1983).

operated exclusively for tax-exempt purposes. Treas. Reg. § 1.501(c)(3)-1(d)(1)(i)(a). To meet the organizational test, CST must show that its Articles of Incorporation do not authorize it to undertake any non-exempt activity. I.R.C. § 501(c)(3)-1(b)(i)(iii). Further, in the event of dissolution, all of its assets must be directed to exempt organizations. *Id.* § 501(c)(3)-1(b)(4). This is chiefly a matter of careful drafting, and the court finds that CST has met this test.

To meet the operational test, CST must show that it operates exclusively for exempt purposes, that it has no substantial non-exempt purpose, and that no benefits inure from it to private individuals. *See* Treas. Reg. § 1.501(c)(3)-1(c). The mere fact that an organization has a tax-exempt purpose or activity does not mean that it does not also have a purpose or activity that is non-exempt. One substantial non-exempt purpose will make an organization ineligible for tax-exempt status, even if all of its other purposes are exempt. *Better Business Bureau v. United States*, 326 U.S. 279, 283 (1945); *Freedom Church of Revelation*, 588 F. Supp. at 696. If CST devotes "more than an insubstantial part of its activities" in support of a non-exempt purpose it would still fail the operational test. Treas. Reg. § 1.501(c)(3)-1(c)(1).

A. CST's Application Must Be Viewed in Light of Other Scientology Activities and Organizations

CST has attempted to disassociate itself from any negative references to be drawn from other aspects of Scientology. For that reason, CST maintains that its status as an exempt organization must stand or fall upon its own documents and activities, not those of other Scientology organizations. *Parshall Christian Order v. Commissioner*, 45 T.C.M. (CCH) 488, 491 (1983). As a general proposition, this is correct. Where there is in fact no meaningful separation between the entities in question, however, the connections between the organizations can at a minimum be considered to see if they bear on the merits of the

application for exemption. In this case, there are a number of reasons that CST's tax-exempt status cannot be considered independently of other Scientology organizations. One is shown in the web of personnel links between CST and other Scientology groups, discussed above at pages 9-10, but there are at least three other connections.

CST is not a church,[36] therefore it must try to qualify as a religious organization.[37] *Compare* Treas. Reg. § 1.501(c)(3)-1(d) *with* Treas. Reg. § 1.511-2. Congress intended that the term "religious organization" have a less restrictive meaning in the tax code than the term "church." *Foundation of Understanding v. Commissioner*, 88 T.C. 1341, 1356 (1987). But the only religious aspect of CST is its connection to Scientology. CST has no exempt purpose absent the religious patina it draws from Scientology. Simply archiving a man's words is not inherently

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[36]CST represents that it is a religious corporation organized to accomplish the activities of a church. Despite its name, CST is not itself a church as defined in the tax laws. It is not "a coherent group of individuals and families that join together to accomplish the religious purposes of mutually held beliefs," which the Tax Court has identified as a defining characteristic of a church. *Church of Eternal Life v. Commissioner*, 86 T.C. 916, 924 (1986). Nor does it have a sufficient amount of the characteristics of a church specified by this court in *Church of the Visible intelligence that Governs the Universe v. United States*, 4 Cl. Ct. 55, 64 (1983). The only characteristic of a church that CST does have is independent legal existence. That alone does not suffice for CST to qualify as a church under the tax code. As an archiving body, CST does not assemble parishioners regularly to worship. *See American Guidance Found., Inc. v. United States*, 490 F. Supp. 304, 306 (D.D.C. 1980). It provides Scientology services to its staff members, but this is incidental to its chief stated function of making an archive. The incidental provision of religious services is not sufficient to qualify an organization as a church. *Foundation of Understanding*, 88 T.C. at 1357 (citing *De La Salle Inst. v. United States*, 195 F. Supp. 891, 901 (N.D. Cal. 1961)).

[37]The distinction matters because churches receive more favorable treatment under the Internal Revenue Code than do religious organizations. For example, churches may be investigated by the IRS only in accordance with strict nd specific procedures specified in I.R.C. § 7611.

an exempt purpose. *See, e.g., Senior Citizens Stores, Inc. v. United States*, 602 F.2d 711 (5th Cir. 1979); *Miedaner v. Commissioner*, 81 T.C. 272 (1983); *Western Catholic Church v. Commissioner*, 73 T.C. 196 (1979), *aff d*, 631 F.2d 736 (7th Cir. 1980). CST therefore derives its religious character, not from its activities *per se*, but from Scientology. CST recognizes this in its Articles of Incorporation: "[T]he corporation is formed . . . [t]o serve as a means of promulgating . . . the religious faith of Scientology around the World . . . ." If the documents CST is preserving are religious, it is because they are the scriptures of the Scientology religion. If CST has a religious purpose it is to further the interests of Scientology by creating a durable record of its founder's teachings. This inextricably links CST to other Scientology organizations.

CST is also linked to Scientology through its authority to control the religion's income-producing property. CST has the power to dismantle RTC by taking over the religious trademarks and use of the Advanced Technology, thereby gaining direct control over all Scientology organizations that purchase trademarked material.[38]

CST claims that it does not and will not monitor RTC's use of the religious marks and technology. CST explains that there is no need to do so because any unorthodox use would be immediately obvious. Regardless of how it arrived at the conclusion, however, the point is that one of its obligations is to prevent misuse of the marks and technology. CST's present confidence in RTC has no significance. If CST ignored that element of its charter, one of the assumptions built into LRH's gift would be missing. Monitoring for a misuse by RTC is a form of ongoing oversight. The decision to exercise the option is an ecclesiastical one which would not be readily susceptible to judicial review. Upon exercise of the option, CST would inherit RTC's role as the final voice on Scientology orthodoxy.

[38]This really means all organizations, because only trademarked materials are considered orthodox in the religion.

This would give CST ecclesiastical authority over even CSI, since "CSI itself is ecclesiastically subordinate to RTC." PPFF 17. The conclusion which the court must necessarily draw from LRH's property distribution scheme is that CST has the absolute authority to take control of the bulk of the income-producing property of Scientology.

Indeed, the need for CST to take even the intermediate step of exercising its options may have been obviated. The Commissioner found RTC to be non-exempt. The gift to RTC was conditioned on its obtaining tax-exempt status. If the gift fails, as it appears to have, there is nothing over which to exercise an option. Assuming CST secures tax-exempt status, it would appear destined, as beneficiary of LRH's residual estate, to collect the balance of the income-producing property.[39]

The religious trademarks and rights to the Advanced Technology constitute most of the income-producing property owned by any of the Scientology organizations. The remainder of LRH's income-producing property is already designated for CST. Upon its qualification for tax-exempt status, CST could,

[39]CST represented to the Commissioner in 1985 that it understood its rights to include the following: "[I]n the event it is determined that Religious Technology Center is not exempt, this corporation *will* exercise its options and acquire the marks and materials. . . ." (Emphasis supplied.) In its 1987 Supplemental Submission, CST attempted to back away from this interpretation, but still concluded

> if [the IRS] recognizes CST's exemption, CST would have the power to acquire RTC's rights in the marks and Advanced Technology if RTC's exemption were denied. When its exemption is recognized, CST will receive Mr. Hubbard's estate and become owner of the limited powers of appointment over the marks and the Advanced Technology that Mr. Hubbard retained. As owner of these interests, CST will have the legal right to designate the section 501(c)(3) transferee of RTC's rights in the marks and the Advanced Technology. In the event RTC cannot obtain exemption. *As a section 501(c)(3) organization. CST itself would qualify to receive these rights.* (Emphasis supplied.)

therefore, obtain, by operation of LRH's will, all of the rights LRH reserved when he made his gift to RTC, as well as the copyrights to Scientology scriptures, which presumably constitute the very heart of Scientology. The copyrights to LRH's science fiction works will also devolve to CST under the will. This intellectual property alone was valued at $25,000,000 by the trustee appointed by the court to administer LRH's estate.

In these circumstances, it is at best disingenuous for CST to maintain that it is "independent" of Scientology's ecclesiastical hierarchy. LRH certainly succeeded in creating an entity that is not nominally subject to the ecclesiastical control of other Scientology organizations. Rather, the potential control runs in the opposite direction. CST stands poised to assume a position at the apex of a pyramid of both ecclesiastical authority and financial control over Scientology.

Finally, the converse of CST's control in the area of orthodoxy is that until it obtains tax-exempt status, CST will be as it has been, entirely dependent on payments from other Scientology organizations. Indeed, CST's Articles of Incorporation specifically state that it does not solicit any funds itself, nor does it have any plans to do so.[40] CST states that it alone controls its financial matters. Possibly this is true with respect to how money is spent once held by CST. It has not been true, however, with respect to obtaining the money that CST spends. All of this has come from other Scientology organizations, and could, presumably, be cut off.

In sum, there is a strong link, in fact an identity of purpose, between CST and other Scientology organizations. CST was created to serve LRH as a personal estate-planning device and

[40]The fact that CST does not raise its own funds is itself unusual for a would-be I.R.C. § 501(c)(3) organization, and limits its ability to be independent. In *B.S.W.*, 70 T.C. at 359 the court denied a tax-exemption and stated, "its financing does not resemble that of the typical I.R.C. § 502(c)(3) organization. Petitioner has not solicited nor has it received, voluntary contributions from the public."

to support the work of Scientology. CST would not exist without the rest of Scientology. Its activities and purpose must, therefore, be considered in light of its connection to Scientology as a whole. Although CST has repeatedly declared that it does not "voluntarily" recognize the authority of the Scientology hierarchy and thus is ecclesiastically independent of it, the statement is virtually meaningless in the context of this litigation. CST, therefore, has the burden of dispelling concerns raised by its association with other non-exempt entities.

B. Substantial Non-Exempt Purpose of Scientology

1. Activity Cannot be Confused with Purpose

CST has assiduously developed a record which demonstrates that most, if not all, of its prior activities are directed at preserving scripture. CST does not sell or market achieved material, or make any profit on its activities. But even if CST could show that 95 per cent of its employees did nothing but archive Scientology documents, and only the remaining five per cent were in charge of CST's property interests and finances, that alone would not be enough to secure tax-exempt status. Congress did not intend for a mere quantity of dedicated resources to be the deciding factor in whether an organization is operated for exclusively exempt purposes. Section 501(c)(3) contemplates that the IRS (and the court, if necessary) will inquire into the reality of an organization. "The bare fact that approximately half of each group is composed of not-for-profit organizations does not compel the conclusion that there is absent a substantial nonexempt purpose." *Copyright Clearance Ctr. v. Commissioner*, 79 T.C. 793, 809 (1982); *See also Better Business Bureau*, 326 U.S. at 283.

CST confuses activity with purpose. The law does not. As the Tax Court has held, "The operational test focuses on the purpose and not on the nature of the activity." *Goldsboro Art League v. Commissioner*, 75 T.C. 337, 343 (1980). The Commissioner, and the court, are permitted to consider not just an

organization's activities, but also to inquire into its purposes. The fact that an organization's activities have religious overtones and do not produce profits is no assurance those activities will be tax-exempt. "[T]he critical inquiry is whether petitioner's primary purpose for engaging in its sole activity is an exempt purpose, or whether its primary purpose is the non-exempt one of operating a commercial business producing net profits for petitioner." *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352, 359 (1978); *accord Christian Manner Int'l. Inc. v. Commissioner*, 71 T.C. 661, 668 (1979).

In evaluating the real purpose of a transaction, the Supreme Court has cautioned against uncritical reliance on form as against function. *Gregory v. Helvering*, 293 U.S. 465, 470 (1935), involved a scheme to avoid taxation of corporate distributions by invoking a code provision applicable to reorganizations:

> The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

In like fashion here, CST must demonstrate that it was organized for an independent and bona fide purpose. Given the prior history of Scientology and the peculiar circumstances of CST's birth, it is appropriate to look beyond the flurry of archiving activity and inquire into whether the very existence of CST was brought about primarily to serve the non-exempt ends of other Scientology organizations. Although CST is entitled to

minimize its own taxes, it would be a misuse of I.R.C. § 501(c)(3) if its primary *raison d'etre* was to shield the income of other organizations from tax.

2. Scientology's Preoccupation with Finances

The court has attempted above to describe Scientology's Byzantine management structure and financial arrangements. The task is difficult, due to the proliferation of entities and accounts and the overlap of personnel. Scriptural emphasis on taking in money as well as passive resistance of tax inquiries has been described above.[41] Other courts have encountered this same phenomenon. The commercial character of the scriptures is manifest:

> Scientology income is high in most orgs. But it IS high due to the investment of time and money in earlier years. So if the balance sheets omits all the

[41]Examples of LRH's interest in maximizing income and minimizing taxes, such as the following, are legion:

> Make lots of money. Spend it frugally. So it gives a tax problem. So what? Your accountants should be capable of avoiding tax problems. Whether you do or don't have money, you will always have a tax problem because governments are crazy. The way to solve tax problems is to have money, not to be broke.
>
> Taxes exist only to destroy businesses. Be impudent. Get rich and to hell with them. Governments are just a reactive bank we have to live with for a while. Learn to handle them. But not by refusing to make money or have it.

HCO Policy Letter of 28 January, 1965.

> Now as to TAX why this is mainly anybody's game of what is a PROFIT. The thing to do is to assign a significance to the figures before the government can. The whole thing is a mess only because arithmetic figures are symbols open to ANY significance. So I normally think of a better significance than the government can. I always put enough errors on a return to satisfy their bloodsucking appetite and STILL come out zero.

HCO Policy Letter of 25 June, 1967.

> money that was invested and show only the money that was made, they are false balance sheets. And that is what the government wants us to turn in — a false balance sheet that shows all income as profit with no repayment or retirement of debt.

HCO Policy Letter of 25 June, 1967.

The Doctrine of Exchange discussed previously is another indication of Scientology's preoccupation with money. While the parishioner may believe the exchange to be spiritually beneficial, it still has the hallmarks of a commercial exchange. The Supreme Court also came to this conclusion in *Hernandez*, 490 U.S. at 684, where the Court held that individuals who make auditing payments to Scientology are not entitled to take a tax deduction for them.

Moreover, the doctrine is abandoned in circumstances where LRH deemed it expedient for "rapid dissemination" of Scientology doctrine. In HCO Policy Letter of 1 January AD13, Central Orgs are instructed to process selected celebrities "who are just beyond or just approaching their prime." The scripture goes on to say, "The pay is to be 'Any contribution you would care to make if we have helped.' No other pay is demanded." This desertion of the presumably fundamental Doctrine of Exchange appears to be theologically unprincipled, but it is not unlike a commercial business strategically giving away services in an effort to increase sales by obtaining a celebrity endorsement.

A great deal of money is realized from the sale of auditing services and LRH's books. CSI fixes the retail price of LRH's books, in conjunction with the for-profit publisher, Bridge Publications, Inc. The prices are set with an eye to maximizing dissemination of the works as well as to maintaining a profit margin for the church bookstores. A minimum inventory is mandated by church policy. Further, Scientologists who work in the bookstores are entitled to earn commissions on the books

they sell. There is little, if any, difference between such an arrangement and that maintained by any commercial bookstore. Indeed in the HCO Policy Letter of 14 May, 1959, LRH describes an even less charitable pricing policy for books: "Establish fully the printing cost. Multiply by five. This is the cost of the book to usual buyers. However, a book price can be further increased so that when one gets a 20% discount reduction he pays a whole figure."

The administrative record contains no figures as to the amount of money realized through the sale of LRH books. A court appointed appraiser, however, in valuing LRH's estate for purposes of probate, valued the entire estate at $26,305,706, of which $25,000,000 was the value of LRH's intellectual property, i.e., the copyrights and trademarks of his Scientology publications. That figure, even discounting the value of the E-meter patents and other non-publication elements, does nothing to dispel the appearance of commercial profitability. *See Goldsboro Art League*, 75 T.C. at 344; *B.S.W. Group*, 70 T.C. at 357.

The complexity of Scientology's financial procedures, its dizzying array of reticules, and the potential for virtually constant transfers of funds, inevitably raise questions about the propriety of a tax exemption for CST, due to its links to that system, which will be permanently forged upon a declaration of CST's exempt status. In that event, the asset of the pour-over trust devolve on CST — namely the right to the books, tapes, films and E-meters, along with the accumulated income therefrom. These, in turn, are licensed in part to for-profit entities for distribution. This arrangement simply does not resonate with the image of a tax exempt organization. Instead, it calls to mind Werner Heisenberg's uncertainty principle.[42] In Scientology's case, the opacity is so pronounced as to approach wilfulness. Organizations adjudged exempt simply do not exhibit the finan-

[42]Heisenberg postulated that it is impossible to determine at the same time both the position and velocity of an electron.

cial complexity or the phenomenal pre-occupation with money displayed by Scientology's management churches and organizers. *See, e.g., Universal Life Church, Inc. v. United States*, 372 F. Supp. 770 (E.D. Cal. 1974) (finding that organization that offered religious course of study and accepted, but did not require, payment for its materials was tax-exempt); *National Found., Inc. v. United States*, 13 Cl. Ct. 486 (1987) (holding that foundation that supported other exempt organizations with money it collected from public was exempt because it gave away bulk of money taken in); *Goldsboro Art League*, 75 T.C. at 345 (finding that art league's sale of a few paintings of various local artists unrelated to League's exhibits was incidental to overall exempt educational purpose).

3. CST's Overriding Rationale is to be a Tax-exempt Organization

If CST is to be found tax-exempt, it must be because archiving is its primary purpose and archiving LRH's words is an exempt activity. Further, the court must find that holding the options and receiving LRH's estate are merely incidental to CST's existence. Instead, the court finds that the impetus behind CST was not archiving, charity, or even religious education, but rather was tax planning. Nothing about CST is consistent with its adopted posture as a simple document repository. A number of inevitable inferences from the record, unanswered by CST, lead to this conclusion.

First, there is the plain linkage between CST and the dissolution of CSC, as well as the difficulties Scientology as a whole was having in 1982 with the IRS. Before the creation of CST, CSC served Scientology as a tax-exempt entity. When it became apparent that CSC was likely to lose this status, LRH and the Scientology management restructured both the financial and the ecclesiastical organization of Scientology. CST was created in 1982, during the CSC litigation. It was founded by four non-Scientologist lawyers and Lyman Spurlock, President

of CST and former personal employee of LRH, in the wake of CSC's dissolution.

Sartre wrote that "Man is not the sum of what he has but the totality of what he does not yet have, of what he might be." In like fashion, the court is struck by the centripetal force that will be generated should CST obtain tax-exempt status, and should it choose to exercise its option to take over assets from RTC. Armed with the trademarks and publishing rights, and with tax-exempt status, CST will be poised in the center of all of Scientology's financial resources, in position to exert a strong gravitational force on Scientology's income-producing assets.[43] If CST were exempt as a church, it would be virtually insulated from public view, since it would not be required to file an annual return. I.R.C. § 6033(a)(2)(A)(i). If CST were to qualify as a religious organization, it would be responsible for filing only an informational return. I.R.C. § 6033(a).

If CST succeeds in its quest for exempt status, it will control the trademark and publishing rights to all of LRH's works.[44] Those rights constitute most of Scientology's income-producing property. The trademarks and publishing rights are the source of the Advanced Technology from which all income production ultimately flows. Books and tapes must be orthodox. Provision of auditing services is impossible without authorized books,

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[43]CST states that it would never seek to control these assets, or use them in any way inconsistent with the stated religious purposes of Scientology. CST has provided only conclusory statements of its own officers as evidence of CST's intentions. The court in *People of God Community v. Commissioner*, 75 T.C. 127, 132 (1980), found similar conclusory assertions unpersuasive and insufficient to carry petitioner's burden of proof. Moreover, CST has stated on at least one occasion that "it will exercise its options and acquire the marks and materials." DPFF 61.

[44]It is no answer to say that the court's concern is with potential developments that the court is merely speculating. There is nothing speculative about LRH's will, the denial of RTC's exemption, and the value of the marks and copyrights. The culmination of the events set in motion by LRH lacks only the court's sanction.

tapes, and E-Meters. These materials produce money in sufficient quantities to allow CSI to hold millions of surplus dollars in its central reserve account. The potential for abuse of the options and copyrights therefore is considerable. CST would not be obligated to donate the money to other non-profit groups, or even to contribute it to Scientology's own central reserves. In fact, once CST has built its archiving facilities, its expenses should decline dramatically, but it will still control millions of dollars worth of income-producing assets.

Next there is the dissonance between the stated, limited purposes of CST on the one hand, with the far reaching implications of the potential financial control over Scientology built into LRH's tax planning. CST has already demonstrated that it can perform its archiving activities on the largesse of other Scientology organizations. Thus, the argument that CST must be self-sustaining is without merit. Its insistence that it was intended to be independent is unpersuasive because, as currently structured, it is not. If the true motivation behind CST were to build an archive, it would have been a simple matter to incorporate an organization and arrange for financing through the central reserves, or to have all Scientology churches contribute to funding the archive, or to have some other straightforward financing scheme.

What other possible purpose could there have been for funneling LRH's estate to an organization with such a nominally limited and innocuous function unless it was the hope that Scientology had achieve the holy grail — an organization with unassailable tax-exempt credentials, yet in control of the income from the myriad sources within Scientology.[45]

[45]Plaintiff has argued that the intention of CST's founders is irrelevant to the determination of CST's status. That is, as long as CST's primary purpose was religious, and it otherwise met the requirements of I.R.C. § 501(c)(3), private motives, in this case the advancement of interests of other non-exempt organizations, would not be relevant. Just as genuinely charitable intentions will not save a commercial undertaking from being commercial, CST argues

This concern is exacerbated by the fact that CST will receive nothing from LRH's estate if it is not deemed tax-exempt. Thus, it appears that despite the stated importance of its archives to the Scientology religion, they were apparently not worth supporting unless they generated a tax exemption. Protecting the use of Scientology trademarks and copyrights is also apparently not worth doing if it will not be done by a tax-exempt organization.

Conditioning the receipt of property on obtaining tax-exempt status is "an element that indicates the possibility, if not the likelihood, that the for-profit corporations were trading on such status." *Est of Hawaii v. Commissioner*, 71 T.C. 1067, 1080 (1979), *aff'd* 647 F.2d 170 (9th Cir. 1981); *see also McGahen v. Commissioner*, 76 T.C. 468, 480 (1981), *aff'd*, 720 F.2d 664 (3d Cir. 1983); *Basic Bible Church v. Commissioner*, 74 T.C. 846, 850 (1980); *aff'd*, *Granzow v. Commissioner*, 739 F.2d 265 (7th Cir. 1984). It becomes apparent that "the sole reason for incorporating the Church and transferring the royalty rights to the book was an attempt to avoid taxes whereby royalty income would be exempt and any contributions would generate a deduction." *Miedaner*, 81 T.C. at 280 (footnote omitted).

CST is linked by a cat's cradle of connections to RTC, CSI, and through them, to the rest of Scientology, thereby belying its claim of disinterest in the activities of other organizations. This fact, coupled with the commercial character of much of Scientology, the difficulty that its management churches have had with tax exemption, Scientology's virtually incomprehensible

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that commercial intentions will not transform a charitable undertaking into an uncharitable one. *Scripture Press Found. v. United States*, 152 Ct. Cl. 463, 469-470, 285 F.2d 800, 804 (1961), *cert. denied*, 368 U.S. 985 (1962). This argument is flawed because it assumes CST's primary purpose was religious. Lacking this premise the argument is irrelevant. The motives of the founders will be considered to the extent they illuminate CST's function and purpose.

financial procedures,[46] its scripturally-based hostility to taxation, the timing of CST's genesis and finally plaintiff's enormous potential for both accumulating wealth and bestowing shelter from taxation, inevitably lead to the conclusion that archiving is not plaintiff's "exclusive" or even chief purpose. The inference is inescapable that CST is merely the latest incarnation of the on-going effort of Scientology as a whole to shelter income from taxation. Consciously or not, CST's organizers reflected an awareness of the truth of Goethe's maxim that "one must be something to be able to do something." The court concludes that CST's real function was to be rather than to do.

C. CST's Lack of Cooperation with the IRS

The court notes an independent basis for rejecting the application. The plaintiff had to demonstrate to the Commissioner, and bears a related burden of proof here, that it is entitled to be exempt from paying taxes. In that connection, it has to be observed that CST's participation in the administrative process reflects a level of hostility and uncooperativeness that is inconsistent with removing doubts. Numerous courts have upheld the denial of an exemption on the basis of an organization failing to provide information requested by the IRS. In denying an exemption to the Founding Church of Scientology, the court noted, "[N]othing we have found in the record dispels the substantial doubts the court entertains concerning [the plaintiff]. Since plaintiff has failed to meet its burden of proof, we hold therefore that a part of the corporate net earnings was a source of benefit to private individuals." *Founding Church*, 188 Ct. Cl. at 500; *Basic Unit Ministry of Alma Karl Schurig v. United States*, 511 F. Supp. 166 (D.D.C. 1981), *aff'd* 670 F.2d 1210 (D.C. Cir.

[46]The court notes that HCO Policy Letter of 15 May, 1968 gives the following instructions regarding explanations of an org's general liability fund: "Refuse to breakdown the calculations on how the fund is computed if demanded by an insurance inspector or tax collector, instead obtain an estimate of coverage costs from brokers recommended by Legal WW, to confirm our cost assignment to fund."

1982); *see also National Ass'n of American Churches v. Commissioner*, 82 T.C. 18 (1984); *World Family Corp. v. Commissioner*, 81 T.C. 958 (1983); *People of God Community v. Commissioner*, 75 T.C. 127 (1980).

The court has referred above to a number of instances in which CST was less than forthright in its dealings with the IRS. Its refusal to provide information even when repeatedly requested, combined with the IRS's experience with other Scientology organizations, made it reasonable for the IRS not simply to accept at face value CST's contentions that it was independent of the Scientology hierarchy, and to probe further. CST failed to respond substantively to the IRS's questions on a sufficient number of occasions during the administrative proceeding.

This behavior is not only understandable from a Scientologist's viewpoint, it is "scripturally" mandated. In HCO Policy Letter of 26 December, 1966, LRH instructed his executives (high church officials) in "Methods of Balking" when faced with a tax investigation. This includes the advice, "Never give such persons access to persons high up in the org - or unit. Turn such over to special personnel who can get the business over with at once and get the agent off the premises soon." HCO Policy Letter of 18 February, 1966 deals with "Attacks on Scientology," and LRH states "Groups that attack us are to say the least not sane. . . These people who attack have secrets. And hidden crimes. They are afraid." Thus, concludes the scripture, the way to deal with these "mad" people is by attacking first, and blankly refusing to cooperate. Finally, HCO Policy Letter of 3 February 1966 states, "ALL OUTGOING MAIL to attorneys, tax cruds, the alleged government, the Council, etc. . . . must be sent to the Legal Officer BEFORE MAILING. . . ."[47]

[47] *See also*, HCO Policy Letter, 25 June 1967, states "[t]he real stable datum in handling tax people is NEVER VOLUNTEER ANY INFORMATION." And from the same letter, "Right now there is a lot of tax yap. And it is being set up to clobber Scientology with huge tax bills in England and the U.S."

The theological hostility to paying taxes evident in the scriptures also supports the close attention of the IRS. Although CST is fully entitled under the Constitution to believe that paying taxes is spiritually wrong, it cannot then be surprised that its position invites scrutiny.[48] Just as a group which advocates violence will attract police observation, a group which has historically displayed reluctance to pay taxes can expect the watchful eye of the IRS. Furthermore, CST's right to oppose and resent the IRS does not change the fact that helping non-exempt groups avoid paying taxes is not the basis for an exemption. Religious belief cannot be used as a magic wand to transform tax avoidance into a tax exemption. *Ecclesiastical Order of ISM of AM, Inc. v. Commissioner*, 80 T.C. 833 (1983), *aff'd* 740 F.2d 967 (6th Cir. 1984), and *cert. denied*, 471 U.S. 1015 (1985). Nor does it excuse CST from dispelling the Commissioner's doubts about it. The IRS was thus justified in finding that CST had failed to carry its burden of proving its exempt status.

CONCLUSION

The court does not question the sincerity of the beliefs of those practice Scientology. Nor does the court hold that Scientology is not a religion. Plainly it is. The limited issue before the court, however, is whether CST has met its obligation of demonstrating that the Commissioner's decision was erroneous. It has not. There was sufficient evidence in the administrative record to support the Commissioner's finding that CST has not shown itself to be an exempt organization under § 501(c)(3). The Clerk is directed to dismiss the complaint.

/s/_____
ERIC G. BRUGGINK
Judge

[48]Tax exemptions are a mater of legislative grace, and organizations seeking a tax exemption "are expected to follow the reasonable standards enacted by Congress and devote themselves exclusively to the pursuit of religious purposes." *Parker v. Commissioner*, 365 F.2d 792, 795 (8th Cir. 1966), *cert. denied*, 385 U.S. 1026 (1967).

APPENDIX
GLOSSARY OF ABBREVIATIONS

A AO-SH - Advanced Organizations - Saint Hill

ASI - Author Services, Inc.

B BPI - Bridge Publications, Inc.

C CLO - Continental Liaison Office

CSC - Church of Scientology of California
CSFSO - Church of Scientology Flag Service Organization
CSI - Church of Scientology International
CST - Church of Spiritual Technology

D DPFF - Defendant's Proposed Finding of Fact

E E-Meter - Electro Meter

F FBO - Flag Banking Officer

FBO INT - Flag Banking Officer International
FEO - Finance Enforcement Officer
FP - Financial Planning

H HCO - Hubbard Communications Office

HCO PL - Hubbard Communications Office Policy Letter

I IPT - International Publications Trust

IRS - Internal Revenue Service

L LRH - L. Ron Hubbard

M MCCS - Mission Corporate Category Sort-out

N NEP - New Era Publications

O OTC - Operation Transport Corporation, Ltd.

P PPFF - Plaintiff's Proposed Finding of Fact

R RTC - Religious Technology Center

S SOR - Sea Organization Reserves

W WDC - Watchdog Committee

WW - World Wide

APPENDIX C
Order on Reconsideration of the Court of Federal Claims

In the United States Claims Court

No. 581-88T
(Filed: June 29, 1992)

CHURCH OF SPIRITUAL TECHNOLOGY,
Plaintiff,

v.

THE UNITED STATES,
Defendant.

ORDER ON RECONSIDERATION

This case is before the court on plaintiff's Motion for Reconsideration (hereinafter "motion"). The court issued its opinion on May 26, 1992, affirming the decision of the Commissioner to deny plaintiff tax-exempt status.

Plaintiff alleges both factual and legal errors in its motion. The court agrees that the following corrections need to be made:

1. The paragraph beginning at the bottom of opinion page 3 will be altered to reflect the issuance of *United States v. Zolin* during the pendency of the instant action, rather than during the administrative proceeding.

2. Plaintiff suggests that the "Church of Scientology of Los Angeles" and "Church of Scientology San Francisco" are in effect listed twice at footnote 8 by virtue of the reference to "141 Class IV churches." The duplication will be corrected. The court does not understand plaintiff's other objections to contradict the contents of the footnote, and makes no other changes. The list does not purport to contain only those organizations which are "separate legal entities" or which actually minister Scientology services. It is a snapshot of the com-

ponents of Scientology as of the time of the completion of the reorganization, whenever they were created.

3. The discussion of the Tax Court's holding in *Church of Scientology of California v. Commission* ("*CSC*"), 83 T.C. 381, 500, 502 (1984) will be corrected as follows. At page 16, first full paragraph, the words "several of the charitable trusts set up by CSC" will be replaced by, the United States Churches of Scientology Trust and the Operation Transport Corporation." The Tax Court's filing was based in part on L. Ron Hubbard's personal control over several accounts within the trust, *id.*, at 487, and his personal control over monies transferred to the Operations Transport Corporation *Id.*, at 499.

4. The last sentence in footnote 35 is no longer a correct statement of the law and it will be deleted.

5. The second paragraph of sub-section F of the opinion will be changed to reflect that RTC collects six percent royalty payments on the Advanced Technology, which are paid only by higher level churches, and not by Class IV churches. The court notes, however, that Class IV churches do make payments to CSI for ecclesiastical services rendered by CSI, and are required to purchase orthodox books and materials the licenses for which trace ultimately back to RTC.[1] See discussion at paragraph 7 below.

6. At page 6 of the opinion, the court recites that "All of the 14 Scientology churches that have received tax-exempt status have been this type of local, Class IV church," citing IRS Publication 78's list of exempt organizations. One such entity listed was "Western United States (Los Angeles)." CST's motion recites that this is inaccurate and misleading because the "Advanced Organization Los Angeles" (apparently the same

[1] As a result of LRH's gift, RTC holds the rights to the trademarks without which auditing and products cannot be orthodox. RTC has granted a license to Church of Scientology International, which in turn has given permission to Bridge Publications Incorporated to publish and sell Scientology books.

organization) is not a Class IV church, and because the "Church of Scientology Western United States" (also apparently the same organization), "houses the American Saint Hill Organization and Advanced Organization Los Angeles." Motion p. 26, citing to Appendix to Brief to October 15, 1990 (hereinafter "P App.") at 329, 355. Although the accuracy of CST's criticism is not manifest to the court, we will assume that it is well-founded and make the appropriate change.

7. CST points out that it is more correct to say that "the vast bulk" of religious materials are purchased from Bridge Publications International ("BPI"), and from New Era Publications ("NEP"), and not "through CSI, the current mother church." Opinion at 8, n.17. The court was perhaps unduly short-circuiting a number of other connections. It notes, therefore, that the following is a more comprehensive statement of these relationships, and it will be substituted for the discussion of Bridge Publications at pages 14-15 of the opinion:

> Bridge Publications, Inc. ('BPI') is:
>
> > . . . a California for profit corporation. BPI publishes and distributes the Scientology Scriptures (including books and recorded tapes), manufactures, repairs and distributes E-Meters, and publishes and distributes fiction works written by L. Ron Hubbard.
> >
> > Sea Org members hold all of the upper level management positions in BPI, and many of its employees are Sea Org members. BPI is organized and operates (to the extent consistent with its status as a for profit business corporation) in accordance with the Scriptures.
> >
> > Prior to the incorporation of BPI in 1981, the publication and distribution of the Scriptures and the manufacture and distribution of E-Meters in the United States were activities of Church of Scientology

of California. Upon incorporation of BPI, Church of Scientology of California (CSC) transferred the assets used in those activities to BPI in exchange for all of its capital stock. In 1982, CSC sold all of the shares of BPI to International SOR Trust, a non-U.S. religious trust. In 1985, International SOR Trust transferred the shares of BPI to International Publications Trust (IPT), which continues to own all of the shares.

IPT is a Scientology religious trust governed by three trustees. . . . . Two of the trustees are non-resident aliens. The third is a United States citizen and resident and a staff member of CSI, holding the position of WDC Pubs, i.e., the member of the Watchdog Committee concerned with ecclesiastical matters relating to the publication, manufacture, distribution and sale of the Scriptures and of the E-Meters.

In addition to the shares of BPI, IPT owns all of the capital shares of a for profit holding company (a United Kingdom corporation) which in turn, owns all of the capital shares of New Era Publications (NEP), the Danish for-profit publisher which publishes and distributes the Scriptures outside the United States. NEP is managed and primarily staffed by Sea Org members.

BPI has the right to publish the Scriptures and to manufacture E-Meters pursuant to agreements with NEP. NEP in turn has the right to produce these items and to license their production pursuant to agreements entered into with L. Ron Hubbard. Under these agreements, BPI pays royalties to NEP with respect to the copyrighted and patented articles, and NEP in turn pays royalties to Mr. Hubbard and his successors in

> interest, with respect to royalties received from BPI and with respect to items published directly by NEP.

P App. pp. 376-77. Thus, BPI is ultimately controlled by three trustees, one of whom is a CSI staffer, the WDC Pubs. The WDC, a function of CSI, is in turn more generally responsible for "oversee[ing] the entire international ecclesiastical management structure for the Church," including publication activities of BPI and NEP. P. App. pp. 366-38, 375-80. BPI and NEP hold the requisite licenses to sell Scientology materials, and any payment made to BPI or NEP eventually devolves to the financial benefit of "Mr. Hubbard and his successors," which include RTC and CST. Furthermore, all religious materials must be orthodox, and only materials licensed by CSI are orthodox. Although it is apparently the pour-over trust[2] that currently receives royalties from the publication rights, it is CST that, under the will, stands to move into the position of ownership of those rights.

Thus, CST not only is positioned to support BPI's for-profit activities by furnishing authentic copies of archived materials,[3]

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[2]See also addition to opinion at page 8, last paragraph of section C.

[3]CST has two roles with respect to films and tapes as well. Under LRH's will, CST stands to take ownership of those assets. It is also responsible for archiving such materials. Nevertheless, until CST's rights are clarified, BPI and CSI will be involved with the receipt of proceeds from the production and distribution of films and tapes. LRH licensed his copyrights in the films to CSC in 1982 for distribution in the United States. Outside-the-United States distribution was to be done by an entity designated by LRH. Golden Era Studios was set up by CSC to reproduce audio tapes and to produce motion pictures. CST represented to the Commissioner that "in 1985, CSC sold the assets of Gold to CSI, and since then all activities of Gold have been conducted by CSI." The United States Scientology Films Trust was created to distribute the films to churches in the United States, "to receive license fees from them, to pay over to CSC its costs of production and thereafter to retain and expend the amounts received from the churches for religious purposes." After having paid for the films, the trust has collected "in excess of $3 million." As to tapes, BPI "is licensed to copy the tapes," presumably under a prior arrangement with LRH.

it stands to receive royalties from the for-profit publishing companies, and, if it exercises its options over RTC, will receive royalties from use of the advanced technology. As to the supplying of Scientology services, in view of CSI's receipt from RTC of the license to use the trademarks, it would appear to have stepped into Mr. Hubbard's shoes to the extent of receiving payments for use of the marks. Presumably if CST exercises its option over RTC, it would be able to control those marks as well, thereby completing its ownership of the publishing rights, the advanced technology, and the marks.

No further changes are required by plaintiff's motion. In large measure it constitutes plaintiff's reassertion of the inferences it prefers to draw from the record and from applicable caselaw. The order will, however, address the following points.

Factual Disputes

1. Plaintiff states that the court's description of the Sea Organization ("Sea Org") as a "way to distinguish Scientologists worthy of great deference and respect" is unsupported by the record. In its response to the initial adverse ruling, CST recited, "The holder of a particular Sea Org rank . . . will be entitled courtesy and respect befitting his rank." P App. p. 324.

Plaintiff also objects to the description of the Sea Org as exercising real control of Scientology. The court sees no need to change its analysis of the Sea Org contained in the opinion, and notes that it is not the first court to come to this conclusion. In *Church of Scientology of California v. Armstrong*, No. 420153, (Super. Ct. Los Angeles 1984), the court stated, "Notwithstanding protestations to the contrary, this court is satisfied that LRH runs the Church in all ways through the Sea Organization. . . ." *Armstrong*, at 9.

Plaintiff objects to the court's characterization of the FBO as a "high-ranking official" of Scientology organizations, claiming instead that the FBO is merely an "employee." The court

notes that "FBO" stands for Flag Banking Officer. The FBO is responsible for handling his respective organization's finances, and ensuring that the organization meets its various financial obligations. Plaintiff itself told the Commission, "The FBOs in the various churches have higher ecclesiastical authority than the other staff members of a church in respect of the matters entrusted to the FBO [the financial prosperity and expansion of the church]." P App. p. 400.

2. Plaintiff states that the court is incorrect in writing that the Finance Enforcement Officer ("FEO") has higher ecclesiastical rank than does the FBO. But CST itself recites, "Like the FBO, the FEO is an employee of and is paid by the church, but is the ecclesiastical superior of all other staff members other than the Executive Director or Commanding Officer. . . ." P App. p. 398.

3. The court's statement at page 16 of the opinion that the Tax Court found no support for the Scientologists' claims of harassment is correct. The Tax Court acknowledged that CSC had been subject to "special scrutiny" by the IRS, and that the IRS's conduct was unusual enough to warrant discussion, but after examining the actual procedure followed by the IRS in its investigation concluded,

> The decision to revoke petitioner's exemption, the detailed and extensive audits of its records, the lengthy post-audit settlement negotiations carried on in good faith, and the final issuance of the notice of deficiency were all valid exercises of administrative authority. We are also mindful that some of respondent's expressed hostility to petitioner's practices is attributable to petitioner's proven efforts to thwart respondent's duty to administer the tax laws.

Id. at 452-53.

4. CST asserts that the following observation by the court at pages 15-16 is "simply untrue": "[c]ourts that have examined the affairs of other Scientology churches have been persuaded that the way in which Scientology operates is often indistinguishable from any commercial activity, and that church resources have been used for private benefit." As plaintiff recognizes, the Tax Court in *CSC* found commercial purposes in Scientology. *CSC*, 83 T.C. at 490. The Supreme Court held in *Hernandez v. Commissioner*, 490 U.S. 680 (1989), that Scientology parishioners could not take a tax deduction for payments made for auditing services. The Court ruled that "these payments were part of a quintessential *quid pro quo* exchange: in return for their money, petitioners received an identifiable benefit, namely, auditing and training sessions." 490 U.S. at 691.[4] The Superior Court of Los Angeles County also agreed with the French police agency it quoted in *Armstrong*, "'[Scientology] under the pretext of 'free humans' is nothing in reality but a vast enterprise to extract the maximum amount of money from its adepts . . . . '" *Armstrong*, *supra* slip op. at 8. Courts have also found private financial inurement. In addition to the Tax Court in *CSC*, the Court of Claims, in *Founding Church of Scientology v. United States*, 188 Ct. Cl. 490 (1969), found financial inurement to the private benefit of LRH and his family based on informal loans made to LRH.

5. CST contends that the following statement is "false": "The IRS did not say it would never consider CST's application separately, only that until the apparent connections were explained, it could not." Op. at 18. The IRS's position throughout the administrative proceeding, as reflected in the record, was that it *could not* make a ruling about CST until it was satisfied that there was no significant connection among any of the three entities. "As we indicated . . . the interrelationships among the organizations and individuals involved, including the Church of

[4]We note that Webster's defines commerce as the "buying and selling of goods." Webster's New World Dictionary, New York, 1988.

Spiritual Technology, *makes it impossible to separate any one applicant from the others* for issuance of a ruling." P App. p. 158. (Emphasis supplied.) As plaintiff concedes, "CST was told . . . the IRS would not rule on CST's application before completing consideration of CSI and RTC." Motion p. 31.

6. Plaintiff argues that Religious Technology Center's request for tax exempt status has not been denied stating that, "The IRS's denial of exemption is simply the IRS's position." Motion p. 10. The "IRS's position" is a legally significant act. That the decision is appealable to a court (there was no appeal) does not deprive it of effect.

7. CST continues to argue that "there is no 'Doctrine of Exchange' per se in Scientology," and that the "Court's conclusion that the so-called 'Doctrine of Exchange' mandates that religious services be purchased for cash also is unsupported by the record." Motion at 21-22. Without discussing again those citations referred to in the opinion, the court notes additionally that the Supreme Court in *Hernandez* found that a "central tenet of Scientology [is] the 'doctrine of exchange,' according to which any time a person receives something he must pay something back," 490 U.S. at 685, and that the church "categorically barred provision of auditing services or training sessions for free." *Id.* at 692, citing a policy directive that "Price cuts are forbidden under any guise. 1. PROCESSING MAY NEVER BE GIVEN AWAY BY AN ORG."

8. CST suggests that it is "ironic" for the court to rely on the decision of the Court of Claims in *Founding Church of Scientology v. United States*, 188 Ct. Cl. 490, 412 F.2d 1197 (1969), in view of the asserted fact that "the Founding Church's subsequent claim to exempt status was recently sustained in a Church tax examination," citing the opinion of Judge Margolis in *Founding Church of Scientology v. Commission*, No. 91-1176T Slip Op. (May 27, 1992). The court makes two observations about CST's comment. First, it is completely irrelevant to

the Court of Claims opinion and the opinion in this action. Second, it is inaccurate at best to cite the 1992 opinion as support for the proposition that Founding Church's tax exempt status was sustained. As the opinion makes clear, the church made a unilateral decision to hold itself out as a tax exempt organization based on its own determination that its circumstances had changed from the earlier revocation. Because of the time limit in I.R.C. § 7611 (c)(1)(A) the IRS issued a "no change" letter. The plaintiff was unsuccessful, however, in its effort in the Claims Court to force the IRS to add it to the published list of exempt organizations. The complaint was dismissed for lack of jurisdiction. What is ironic is that CST would cite Judge Margolis' opinion, which it seeks to have reconsidered, as support for the proposition that the exempt status of the Founding Church was "sustained."

9. CST criticizes what it refers to as the court's speculation based on a "contrived chain of events." Particularly it challenges the court's analysis about its ability, assuming it is found to be exempt, to designate itself as successor in interest to RTC which appears to have failed in its attempt to be recognized as tax exempt. It recites in its brief that "CST does not hold this power to designate," inexplicably citing page 640 of its own appendix, at which the following appears: "As owner of these interests, CST will have the legal right to designate the section 501(c)(3) transferee of RTC's rights in the marks and the Advanced Technology in the event RTC cannot obtain exemption. As a section 501(c)(3) organization, CST itself would qualify to receive these rights."[5]

---

[5]CST's statement at footnote 16 of its motion that "[i]t is legally impossible that any holder of the power could appoint itself as RTC's successor," is flatly contradicted by plaintiff's previous representation. *See* re-issued opinion at 24 n.39.

Conclusions as to CST's Primary Purpose

Plaintiff argues that the court has misapprehended the organizational test. The organizational test of I.R.C. §501(c)(3)-1(b) is, as the court stated, *chiefly* a matter of careful drafting. The cases plaintiff cites allow the possibility of looking beyond the four corners of the organizing documents where the documents seem to allow the organization to engage in non-exempt activities. Courts have looked to the actual motives and surrounding circumstances to determine an organization's good faith. *See, e.g., Taxation With Representation v. United States*, 585 F.2d 1219, 1222 (4th Cir. 1978); *Colorado State Chiropractic Soc. v. Commission*, 93 T.C. 487, 495 (1989). Here, CST's Articles of Incorporation were carefully drafted. As drafted, they describe an exempt purpose. That conclusion does not, as plaintiff suggests, preclude a related inquiry into the operation of the entity. See also discussion at opinion 23-24. As the court in *Taxation With Representation v. United States*, 585 F.2d 1219, 1222 (4th Cir. 1978), cited by plaintiff notes, "[t]o some degree, 'organized' cannot be separated from 'operated,' for the true purposes or organization may well have to be drawn in the final analysis from the manner in which the corporation has been operated." (citation omitted).

CST is correct that there is nothing *per se* improper or unusual about conditioning a gift on achieving exemption from tax. Circumstances can arise, however, in which the fact of such conditioning is relevant to determine whether the stated purposes of an organization are secondary to the real purpose of "trading of such status." *Est of Hawaii v. Commission*, 71 T.C. 1067, 1080 (1979). *See also* opinion at 28.

Scope of Review

Plaintiff argues that the court has exceeded the scope of permissible judicial review by going beyond the Commissioner's stated grounds for denial. The Commissioner

based his adverse decision on the grounds that CST had failed to establish that it was operated exclusively for exempt purposes, that it was operated for a substantial non-exempt commercial purpose, that it was operated for the benefit of private interests and that its net earnings inured to the benefit of private individuals. P App. pp. 889-899. The court upheld the Commissioner's ruling on the grounds that CST was operated for a substantial non-exempt purpose, and that CST had failed to carry its burden of establishing itself as an exempt organization. The court's conclusions were based on the same evidence and underlying concerns as those of the Commissioner. Both the court and the Commissioner found it impossible to regard CST apart from the rest of Scientology. Both looked to the fact that the same personnel were in charge of CST and other non-exempt Scientology organizations, the latter having direct connections to Central Reserves and the rest of Scientology's finances. Both concluded that CST had not established "that [its] relationship with the new entities furthers [its] exclusively exempt purposes." P App. p. 896. The relationship was seen as especially relevant in light of the commercial character of other Scientology operations. Both rulings presuppose an underlying motive of avoiding the tax liability that would otherwise be incurred. Plaintiff was not prejudiced by any new evidence or argument. For that reason the cases cited by plaintiff are inapposite.

The opinion of May 26, 1992 is vacated and is being reissued contemporaneously herewith to reflect the changes outlined above. In the court's view they are not substantive corrections and thus do not require comment from defendant.

/s/_____
ERIC G. BRUGGINK
Judge

APPENDIX D
Order of the Court of Appeals Denying Petition for Rehearing

ORDER

Before MAYER, Circuit Judge, MICHEL, Circuit Judge, and PLAGER, Circuit Judge.

A petition for rehearing having been filed by the APPELLANT,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for rehearing be, and the same hereby is, DENIED.

The mandate will issue on May 3, 1993

FOR THE COURT,
FRANCIS X. GINDHART, CLERK

Dated: April 26, 1993

by/s/_____
Diane M. Frye
Chief Deputy Clerk

cc: MONIQUE E. YINGLING
GARY R. ALLEN

FILED
U.S. COURT OF APPEALS FOR
THE FEDERAL CIRCUIT
APR 26 1993

CHURCH OF SPIRITUAL TECH V. US, 92-5155
(CLM - 581-88 T)

FRANCIS X. GINDHART, Clerk

Note: Pursuant to Fed. Cir. R. 47.8 this order is not citable as precedent. It is a public record.

APPENDIX E
Judgment of the Court of Federal Claims

In the United States Claims Court

No. 581-88 T

CHURCH OF SPIRITUAL TECHNOLOGY

v.

THE UNITED STATES

JUDGMENT
FILED JUN 29 1992

Pursuant to the order and opinion filed June 29, 1992,

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that the complaint is dismissed. Costs to defendant.

David A. Lampen
Clerk of Court

June 29, 1992

By:/s/_____
Deputy Clerk

NOTE:As to appeal, 60 days from this date, see RUSCC 72, re number of copies and listing of all plaintiffs. Filing fee is $105.00.

APPENDIX F

Unofficial Transcript of the Oral Argument on the Merits Before the Court of Appeals

The next case is 92-5155 -

Church of Spiritual Technology v. United States

YINGLING: Good morning, Your Honors, may it please the Court.

This is an appeal from the Claims Court's denial of a declaratory judgment that Church of Spiritual Technology ("CST") is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code.

CST is a Church of the Scientology religion formed in 1982. It is the beneficiary of the estate of the founder of the religion, the late L. Ron Hubbard. Its primary purpose is to preserve the Scriptures of the Scientology faith, to ensure that Mr. Hubbard's religious teachings will be available to mankind forever.

THE COURT: Counselor we know all that from the brief, the question we have to decide is where is the reversible error by Judge Bruggink.

YINGLING: The reversible error lies in the fact that Judge Bruggink in the Claims Court misapplied the procedural law governing declaratory judgements in that he exceeded the statutorily mandated scope of review under section 7428 of the Internal Revenue Code and he also misapplied the substantive law of tax exemption under, because he misapplied the operational tax under section 501(c)(3). Because both of those errors are errors of law they are subject to plenary

review in this Court rather than the clearly erroneous standard.

THE COURT: Where do you see the error?

YINGLING: Section 7428 provides the jurisdiction that a Court has in its declaratory judgment action and there are three principal limitations on the Court's review under section 7428. The review must be limited to the facts in the administrative records, the facts that the applicant submitted must be assumed to be true, and the Court must base its decision upon the reason provided by the Internal Revenue Service in its final determination letter. That's where the Court's errors lies, in principle number three, primarily; although it also ignore the first two principles.

THE COURT: How so? I don't follow you.

YINGLING: Because it ruled on a ground that was not raised by the Internal Revenue Service in its final determination letter. In fact the grounds on which the Court below based its affirmative decision was not raised by the government until government counsel raised it in oral argument.

THE COURT: What are you referring to when you say the grounds?

YINGLING: The ground being that the Church of Spiritual Technology was not formed for the purpose stated in its organizational documents, that being to preserve the Scientology Scriptures, but rather that it was formed simply as a subterfuge, as a pretext to gain tax exemption and then somehow take over the Scientology hierarchy. That was the ground on which the Court below based its affirmative decision. That ground was not raised

by the Internal Revenue Service. Throughout the five years (interruption) . . .

THE COURT: Wait, counsel, wait a minute. The fact that the organization was formed for the purpose of tax avoidance or what have you is not an independent ground. As I understood the problem, the question was whether this organization is an organization in which no economic activity inures to the benefit of the owners. Right?

YINGLING: No, Your Honor.

THE COURT: That's not the ultimate question?

YINGLING: No, Your Honor. The Court below never addressed the question of inurement, although that was a ground that was originally raised by the Internal Revenue Service its in final (interruption) . . .

THE COURT: Isn't that the test under the statute for what a eleemosynary organization, a tax exempt organization, can be?

YINGLING: That certainly is one of the tests under the statute, Your Honor, and the government conceded in the Court below that that was not an issue in this case. That there was no evidence of inurement on the part of this organization.

THE COURT: What was the government's grounds then for denying tax exempt status?

YINGLING: In the final adverse ruling, the government took the position that the organization had a substantial non-exempt purpose because it assisted the Church hierarchy in marketing Scientology scriptures. CST (interruption) . . .

THE COURT: And engaging in economic activity?

YINGLING: Its position was that somehow it provided the Scriptures to the hierarchy and thereby assisted the hierarchy in marketing those Scriptures. There is no evidence in the record to establish that. In fact, the evidence is clear that CST provides nothing to the Church's hierarchy and it could no way assist the Church hierarchy in marketing Scriptures even if the Church hierarchy did market those Scriptures.

THE COURT: I though you were addressing the variance between the ground relied on by IRS and the ground relied on by Judge Bruggink.

YINGLING: I was initially, Your Honor, until I got another question, but I can go back to the variance.

THE COURT: Finish your answer to his question, but I don't think you answered the earlier question so I would like for you to go back to that when you are finished.

YINGLING: Well, I believe I now answered Judge Plager's question. There was no inurement in the Court below and no evidence of inurement.

With respect to the variance, the Court below is confined to the reasons the IRS states in its adverse ruling for determining whether or not the ruling (interruption) . . .

THE COURT: I think the question is whether a different articulation of the same ground is involved or whether two distinctly different grounds are involved.

YINGLING: That is exactly the question, Your Honor (interruption) . . .

THE COURT: What is your basis for saying that what Bruggink relied on was a distinctly different ground, not just a different articulation than what the IRS relied on?

YINGLING: Because what the IRS relied on was what the organization had done or was doing currently throughout the administrative process. What the lower Court focused on was on something the Church might do in the future. The two grounds could not be more at odds. Any organization might do something in the future that would cause it to lose its exemption. If that were the test, no organization would be entitled to tax exemption under section 501(c)(3). The IRS properly applied section 501(c)(3) in its adverse ruling in looking at the activities of the entity. The Court below went off on a totally different ground and speculated about what the entity might do in the future.

THE COURT: It didn't look to me like that was the entire basis of Judge Bruggink's rulings at all.

YINGLING: I could find no other basis in that opinion, Your Honor. In fact the Court itself said that there was nothing in the record on which it was basing its opinion, but rather it was just drawing negative inferences from what it felt to be omissions in the record and in fact the entire basis of the Court's opinion was nothing but raw speculation.

THE COURT: You had the burden of proof, correct?

YINGLING: Yes, Your Honor, we did.

THE COURT: For the IRS and then when you filed a declaratory judgment action you again had the burden of proof?

YINGLING: But the applicant only has the burden of proof, Your Honor, with respect to grounds that the IRS raises in its final notice of determination; to the extent that there are new grounds raised by the government, the burden of proof then shifts to the government on those new grounds. What Judge Bruggink did below was he allowed the government to raise a new ground in oral argument and did not shift the burden of proof to the government with respect to that new ground.

THE COURT: I though that Judge Bruggink in essence simply ruled that you had failed to carry your burden of proving exclusive exempt purposes.

YINGLING: That was a brief alternative holding that Judge Bruggink made, but his affirmative decision was not a failure to establish decision. But it is interesting that you point that out because the government has apparently abandoned Judge Bruggink's affirmative decision after inviting that decision, after inviting the Court below to go outside of section 7428 (interruption) . . .

THE COURT: I get the feeling that you are shifting grounds on me. Are we now to say that if the alternative ground was brief, it doesn't exist, it can't be relied on. I don't understand where you are going with this.

YINGLING: No, it is not to say that at all, Your Honor.

THE COURT: Why isn't Bruggink's ruling affirmable on the grounds that he was correct when he said that on this record you had not carried your burden of

establishing by proper proof exclusively exempt purposes?

YINGLING: If that is what Judge Bruggink had said, Your Honor, it would be affirmable; that is not what the lower Court said. The lower Court's brief alternative holding on failure to establish also went outside of section 7428 because its supposed failures that were identified by the Court below and relied on by the government again were not raised by the IRS in its final adverse ruling and thus was not properly before the Court below. To the extent there were questions that were raised before the IRS that became the subject of Judge Bruggink's ruling, all of those questions had been answered by the Church during the administrative process. This Church compiled the largest tax exemption record in the history of the tax exemption statute. It did everything (interruption) . . .

THE COURT: Let's not go further afield. So your first ground is that he used a new basis and that's per se contrary to the law. At least (interruption) . . .

YINGLING: Yes, Your Honor.

THE COURT: Then you had a second distinct ground, as I recall, your opening for why his decision is reversible.

YINGLING: Because he misapplied the substantive law under section 501(c)(3). There are two tests under section 501(c)(3). That an entity is organized and operated for exempt purposes. The Court below and the government conceded that this organization, this Church, was organized for exempt purposes. Those purposes being the

propagation and preservation of the Scientology religion.

THE COURT: Was organized for those or said it was organizing for those purposes?

YINGLING: No, the Court specifically found, Your Honor, that it was organized for those purposes and the government conceded that issue. So it was not an issue in the Court below.

THE COURT: Well, when the government talked about purported purposes I read that to mean that the government thought that was some sort of a sham.

YINGLING: The government has made arguments to that effect, Your Honor, but nonetheless (interruption) . . .

THE COURT: Then how do we know that isn't the theory that Judge Bruggink adopted?

YINGLING: Because there is this precise finding in the lower Court's opinion, Your Honor, that this entity was organized for exempt purposes under section 501(c)(3). Of course he then misapplied the operational test because he finds that the entity is organized for exempt Scientology religious purposes but then goes on to find that those very purposes for which it was organized, and he conceded that they are exempt, somehow are not exempt because his opinion in essence is nothing more than an attack on the Scientology religion and a finding that the religion itself is inherently commercial. That is where (interruption) . . .

THE COURT: I read his analysis a little differently. In fact I thought I read it more in your favor then you are giving us because I thought he read it to say that

it could be operated in a non-tax exempt matter and since the relationship of CST to the rest of the organizations engaging in commercial activity was such that that's probably what they were going to do. Isn't that what he said?

YINGLING: No, I don't believe that is what he said, Your Honor. I think that what he said was that CST's activities are hierarchial activities for which it has spent ten of millions of dollars for nothing but an elaborate subterfuge so that it could then take over the Scientology hierarchy free of scrutiny by the IRS.

THE COURT: Could take over?

YINGLING: Yes.

THE COURT: In the future?

YINGLING: Yes.

THE COURT: That's the point.

YINGLING: Exactly.

THE COURT: Well, that's my point. My point is what he was saying is that the structure is such to suggest that CST was being set up do certain things in the future.

YINGLING: I don't believe there was any evidence of that structure in the record, Your Honor. Again that was pure speculation on the part of the Court. The structure itself is not set up for CST to take over the Scientology hierarchy. In fact, quite to the contrary. The record is clear that although CST does hold options to the Scientology religious marks, that it did not anticipate that it would exercise those options in a hundred, or thousand, or even a million years, so the pos-

sibility that might happen was very remote and as I said again the fact that an organization might do something in the future should not give rise to the inference that it will do something in the future or every organization would find itself in the position where it could not qualify for tax exemption.

THE COURT: I thought the inference that he was suggesting was - because that was an option that it said something about the purpose of formation of the entity and spoke directly to its taxability.

YINGLING: Judge Bruggink really erred when he ignored the record that was in front of him. There was no reason for him to speculate. The record in front of the Judge was very clear. Forty-thousand pages of five year's operating history of this entity and all of its activities during that five year period, as the government conceded, and the Court acknowledged, went to its exempt purpose of preserving the Scriptures of Scientology. The Court should not have speculated. The Claims Court in the *Church of Visible Intelligence* in that same Court refused to speculate about what an entity might do in the future and Judge Bruggink (interruption) . . .

THE COURT: You are missing my point. What you are characterizing as speculation about what an entity might do in the future could also be construed as drawing a backward inference about why it was formed in the future place.

YINGLING: That's correct.

THE COURT: One might not be permissible to speculation about what it might or might not do in the future,

but that doesn't mean that the inference about original purpose would be improper.

YINGLING: The inference is improper, Your Honor, if there are uncontradicted facts in the records to show that there is no need for that inference or if the inference is not based on any factual analysis in the record and that is exactly what Judge Bruggink did.

THE COURT: You have to show more than just that other inferences could have been drawn or perhaps a decisionmaker should have drawn no inference. You have to establish, seems to me, that the inference that he did draw was impermissible.

YINGLING: Well, I think we do establish that, Your Honor, and we establish that by showing that the organization has done in its five year operating history exactly what it said it would do and there was nothing in its operating history, nothing in its activities, that would give rise to the kind of speculations and inferences that the lower Court made. That is how an entity meets its burden of showing that it operates under section 501(c)(3). It shows that its activities meet its purpose.

THE COURT: Let's examine that. The test is that its organized and operated for exempt purposes. Let's assume for the moment that everyone can see that its organized for exempt purposes. The questions is - does it meet the "operated" test - right?

YINGLING: Yes, Your Honor.

THE COURT: The trial judge drew a distinction between activities and purposes - the purpose of determining whether it's operated as a tax exempt organization. And what the trial judge said was

that you're confusing your past activities, and even your current activities, all of which are indeed tax exempt - preserving the records, etc. - with the purposes of the organization for its operational purposes, and he extracted - the purposes is an extraction, not a fact. Now he said that the purposes of this organization for meeting the test of operating in a tax exempt manner or - and then he examined the whole environment of the organization and concluded the purposes were for non-tax exempt activities. Now do you disagree with his analysis - that is, he shouldn't have looked at the purposes, he should have stayed with the activities, or are you saying that his conclusion from the total picture of what the organization proposes is a bad conclusion?

YINGLING: I'm saying both, Your Honor. First of all, he misapplied the operational test when he went beyond the activities in order to try to determine purposes. The law is clear under section 501(c)(3), the way you ascertain the purposes of an entity is by looking at its very activities. The Court asked at one point (interruption) . . .

THE COURT: And you don't look at the context of the organizational structure?

YINGLING: Certainly you can look at that too, but you have to look at how the organization function (interruption) . . .

THE COURT: Now wait a minutes, either it was permissible for him to look beyond current activities or it wasn't and I'm getting a waffled answer as to what I'm hearing in response to Judge Plager's question.

YINGLING: The activities are what determines the purpose (interruption) . . .

THE COURT: It is impermissible to look at the context?

YINGLING: It certainly is impermissible if there is no basis in the record to give the Court a reason to speculate about some other purpose. The purpose was (interruption) . . .

THE COURT: Speculation versus inference goes to whether there is some evidentiary basis, but that is not the question. The question isn't what was the evidence? The question is what is relevant permissible fact to look at, and the question by Judge Plager was, may the decisionmaker look at the context, and I still don't hear your answer to that.

YINGLING: This organization never denied that its application (interruption) . . .

THE COURT: Isn't this a yes or no answer; either the context is a permissible thing to look at or it isn't.

YINGLING: The context is not permissible if when looking at the context the Court ignores the activities, which is what the Court below did. It simply ignored the activities (interruption) . . .

THE COURT: I don't think he ignored the activities. What he said was I'm not persuaded that these activities truly reflect the purpose.

YINGLING: He had to ignore the activities because the activities speak for themselves. Why would an entity literally pour tens of millions of dollars into holes in the ground to preserve Scriptures if that were not its true purpose? The Court's opinion frankly is pure fiction; it simply speculated what this entity might do at some time in

the future and ignored the 39,000 pages of evidence it had in front of it about what this entity really did do.

THE COURT: Why don't we let the - let's hear from the government - you have used up all your time, but we will give you the rebuttal time that you have reserved anyway - actually we used a lot of your time with questions, so you can have your full rebuttal.

Let's hear the government's side of the case now.

RAPP: Good morning, Your Honors, W.C. Rapp for the United States. The Court please, I had to check the captions on my documents before I stood up here to make sure I was listening to an argument in the same case that I handled below and that I briefed here. I am reminded of a riddle (interruption) . . .

THE COURT: We are not interested in your incredulities of what she said, just tell us why she was wrong.

RAPP: Counsel for Scientology primary relies upon the notion that what Judge Bruggink did below was very different from what the Commissioner said in his final letter. The final letter is in the record, it is at the - in the exhibit supplement it begins on page 889, it's a letter of July 8, 1988. On page 894 the Service said "your archival activities relate to the materials constituting the Scriptures of Scientology. These material consist of the written and spoken words of L. Ron Hubbard on the subject of Scientology. Prior to his death, Mr. Hubbard held the copyrights on these materials. The works you collected were being commercially exploited by Mr. Hubbard and

some of the organizations licensed by him. You were supported by income paid to you by some of the organizations engaged in this exploitation - notably Religious Technology Center, Church of Scientology Flag, a subordinate of Church of Scientology International.

THE COURT: What are you reading?

RAPP: From page 894 of the Exhibit Supplement to the Appendix, Your Honor. That paragraph concludes on page six of the letter. You were thus performing a function that was benefitting these organizations and further their objective of marketing Scientology products and services. It seems to me, Your Honors, that that's no more than different wording of the same sort of formulation that Judge Bruggink used in his opinion below. What Judge Bruggink was charged with doing was determining whether the purpose of this organization was tax exempt and whether this organization had proved, had established, before the Commissioner, before the Court below, that its purpose was tax exempt.

THE COURT: Now does purpose go to organization or to operation?

RAPP: Well, Your Honor, there are two tests - it has to be organized as well as operated exclusively for tax exempt purposes. The way that the Service's (interruption) . . .

THE COURT: They were coextensive and not alternatively?

RAPP: Well, yes, Your Honor, ordinarily the Service and the cases had treated the organizational test as being almost entirely limited to whether the

documents that form organizations had been drafted properly and perfect their requirements.

THE COURT: They met the test?

RAPP: Yes.

THE COURT: They had good draftsmen.

RAPP: Then that having been fulfilled, as it was in this case, the question is what is the purpose of the organization and operation. This organization certainly does do (interruption) . . .

THE COURT: Do you agree with Judge Bruggink's view that their activities are not necessarily the evidence of their purpose - that you can look at the whole array of related environment?

RAPP: Yes, Your Honor, I think its absolutely necessary particularly in a situation like this.

THE COURT: Can you look at what they may do in the future?

RAPP: I think, Your Honor, that we have no more than a semantic problem with whether or not what the Court below did was to look at what the organization might do in the future. I think that what the Court below did is examine the legal relationships between this organization and the rest of worldwide Scientology and came to the conclusion that it was so inextricably intertwined with the rest of the worldwide Scientology that it was not possible on the record before him to conclude that it is established, that it was operated for exclusively for tax exempt purposes. The point that Judge Bruggink made below was that this organization sits at the middle of international Scientology. This is not a conclusion that Judge Bruggink speculated his

way to; it is not a conclusion that he invented. Scientology, in this case, told us on page A1324 - an excerpt from the protest of the Service:

> L. Ron Hubbard's gift to the religion he found and nurtured and so loved is almost complete. All that remains is for the Service to recognize the CST is an organization described in section 501(c)(3).

At that time, CST will become full legal owner of all property and interests related to the Scientology religion except for those interests Mr. Hubbard previously assigned to RTC. These properties have enormous potential; they are the future of the Scientology faith. That is what they told us; neither Judge Bruggink nor the Commissioner speculated that upon finding that this organization was tax exempt it would receive the residuary of L. Ron Hubbard's estate and own everything with respect to Scientology as well as other things, but would own everything which Hubbard owned that had anything to do with Scientology, except for the property that had been previously granted by Hubbard to the Religious Technology Center. That property, however, is also not without the grasp of this Appellant. At page A775, the terms of the options over the only property having to do with Scientology - that this organization will not own directly, once it's found, if it's found to be tax exempt, that owned by RTC. Here are the terms of the option - this is by the way from CST's finding of facts below, not even our findings of fact. CST can acquire the marks, the trademarks, and the rights to the advance of technology if any

one of three conditions occur. These are conditions described by CST as narrowly defined. Judge Bruggink didn't think they were narrow and I'll leave it to Your Honors to decide.

1) If RTC fails to maintain the "ethical use" of the property in accordance with the Scientology Scriptures;

2) If the property is in danger of appropriation by an entity outside of, or hostile to the religion; or

3) RTC permits the property to be used in a way that is both contrary to the Scientology Scriptures and seriously damages the religion of Scientology or the image or reputation of L. Ron Hubbard.

I suggest, Your Honor, that is a very broad, virtually unreviewable standard by which this organization has power over the only property having to do with Scientology that it will not already own if it is tax exempt.

THE COURT: What does the [inaudible] of the options term?

RAPP: The point, Your Honors, proves, what it proves, Your Honor, is that the relationship of this organization, as Judge Bruggink found, the relationship of this organization to the rest of worldwide Scientology is simply inconsistent with its stated and argued purpose as a mere archiver, as a mere preserver of the Scripture of Scientology.

THE COURT: Aren't you really telling us that it is likely in the future there going to go beyond their tax exempt constraints?

RAPP: I think that certainly a possibility, Your Honor (interruption) . . .

THE COURT: But we can't deny them tax exempt status on the possibility that it might go beyond.

RAPP: I think that that's right, and I don't think that's what the Court did below and that's certainly not what I'm arguing this morning. I am not suggesting that the Court speculate that this organization may begin a project involving space travel. I am simply pointing out that this organization is inextricably intertwined with international Scientology in a manner which is inconsistent with its stated purpose as mere archivers and that because of that inextricable intertwining this organization was unable before Judge Bruggink to establish that it was operated for tax exempt purposes.

THE COURT: Is the option on the intellectual property of the other entity critical to your case?

RAPP: It certainly is extremely important. There is another power which the organization has over the property that RTC has. At the time that these rights, the property was granted to RTC, Hubbard himself retained the right to appoint that property to some other tax exempt Scientology organization if RTC's tax exempt application failed.

THE COURT: Well, whether it comes directly from RTC or indirectly through the side door, I don't think it's too important, at least not to me for right now. My question to you is more fundamental. My question is - is the ultimate ownership of those

intellectual property rights or the contingent future ownership critical to your case?

RAPP: Yes sir, because without that substantial connection, without that dominion over property essential for the practice of Scientology anywhere in the world, assertions by CST, not speculated by the government, without that connection then it is much more difficult to come to the conclusion on this record that not enough has been shown by this organization.

THE COURT: What was the significance of you telling us that their income came from another entity of the Church?

RAPP: The organization that's before you this morning, Your Honor (interruption) . . .

THE COURT: You said inextricably intertwined about eight times and you talk about it being at the center of a whole arrangements of entities, but then when we get the specifics it seems like you are only talking about the intellectual property right ownership which can come to this entity by one of two different devices, and I'm trying to figure out what happened to the rest of this pattern of intertwining, or does it consist only of the patents and so forth.

RAPP: Well, Your Honor, it consists primarily of the rights with respect to the intellectual property, but Scientology is a religion which, according to CST, must be practiced in an orthodox manner in order to be effective, according to their system of beliefs. The guarantee of that orthodoxy comes by materials and services being delivered with the imprimatur of these marks and thus

these marks and the technology that goes along with them are absolutely essential to and vital to the practice of Scientology anywhere, and thus whoever has (interruption) . . .

THE COURT: What about her argument that - listen - if they capture the intellectual property in the future then revoke their section 501(c)(3) status, but for now why shouldn't they have it. What about that argument?

RAPP: There are two reasons, Your Honor, one is what is required in a case like this is the determination that the Court below made of what the purpose of this organization is in its operation and the Court below views (interruption) . . .

THE COURT: You agree the archiving is okay?

RAPP: There is certainly nothing wrong with the archiving. Remember (interruption) . . .

THE COURT: You have to go beyond archiving and find that they are doing something else now?

RAPP: No, I don't think that we have to find that they are doing anything else now (interruption) . . .

THE COURT: Then what is it we have to find?

RAPP: We have to find what the purpose of the organization is in its operation, and Judge Bruggink found (interruption) . . .

THE COURT: You have to find out that their "now purpose" goes beyond what they are currently now doing.

RAPP: Precisely, Your Honor, and I think it is (interruption) . . .

THE COURT: And you're saying that they way we get there is by looking at what they might do in the future?

RAPP: No, let me give an example. Your Honor, if I have an option over your home that I can exercise and acquire total ownership of your home by paying a dollar (interruption) . . .

THE COURT: If you pay my price you can have it.

RAPP: Well, oh no, Your Honor, I don't have to pay anything; simply upon my whim I acquire your home. I think that you and I have a very changed relationship now than the one obtained previously. That is the situation that we have here. We have an organization in the center of Scientology which has the right to acquire property vital to the practice of Scientology. Its influence, its connection to the rest of Scientology is therefore not dependent upon it actually acquiring legal title to the property. But because of the existence of its right to do that, I would point out also in response (interruption) . . .

THE COURT: Its current right. You're saying it has a current right (interruption) . . .

RAPP: Yes sir.

THE COURT: A current right that can be looked at just as we can look at current activities.

RAPP: Exactly.

THE COURT: In deciding what its current purpose is.

RAPP: Precisely.

THE COURT: Now let me ask you one further question, Mr. Rapp, before you run out of time, and that is - what is the allocation of our standard of review situation here - that is - are we reviewing the trial judge on this issue for clear error or is this a question of law that we review - what deference

are we obligated to give the trial judge's findings?

RAPP: Your Honor, the assault that is made on this appeal is that there was no support in the record for the factual findings made by the Court below.

THE COURT: And where did that lead you?

RAPP: That leads me to the conclusion that you must find that there been clearly an erroneous conclusion made by Judge Bruggink. He concluded that on this record the organization had not explained adequately its relationships and the reasons for its relationships to the rest of worldwide Scientology; that's clearly a factual finding.

I would point out that you mentioned a source of funds for the organization.

THE COURT: Well, you mentioned it and I was trying to figure out if it was part of your case or not part of your case.

RAPP: Well, I think it goes to show again the relationships between this organization and the rest of worldwide Scientology.

THE COURT: I take it is part of your case?

RAPP: Absolutely. The organization depends for its operation, at least until it receives the rest of Hubbard's estate, on money from other Scientology organizations.

THE COURT: Which are or aren't tax exempt?

RAPP: Primarily, they are not tax exempt.

THE COURT: So is the underlying theory of IRS here that this whole thing was a sham to try to shelter income under a section 501(c)(3) tent?

RAPP: I think that is one way to look at what the relationships are; I think that that's a much broader view than is necessary. I think that the narrow view, the only one that is necessary, is that this organization's relationship to the rest of Scientology remains on this record unexplained - the findings, the factual findings of the court below.

THE COURT: Then you're not saying that it's proven that their purposes are commercial, you're just saying at bottom that they haven't proven on this record that their purposes are exclusively noncommercial.

RAPP: That is all that's necessary to affirm, I think that's really all that Judge Bruggink found.

THE COURT: So all they have to do now is just reapply and supplement the record and perhaps they will satisfy their burden.

RAPP: That is one possibility, Your Honor - if there are no further questions.

THE COURT: Mrs. Yingling I have two questions for you.

YINGLING: Yes, Your Honor.

THE COURT: First question - what is wrong with the government's argument when it says we can look at their "now activities" and their "now powers" and rights in determining what their "now purposes" are?

YINGLING: There is nothing wrong with that, Your Honor, but since there were no activities with respect to those specific powers, the holding of the options, then there were no operations of the entities that would be in conflict with section 501(c)(3).

THE COURT: You switched on me. Do you agree that we can look at the "now rights," whether those rights are being exercised currently or not is irrelevant - they exist.

YINGLING: They exist, that's correct, Your Honor.

THE COURT: And we look at those "now rights," could the trial judge look at those "now rights" in determining "now purposes?"

YINGLING: The purposes must be found in their operations, as government's counsel conceded in response to your question, and since there were no operations or activities with respect to those rights, while there is no question that the Court can acknowledge that the Church held those rights, they do not determine the Church's purpose.

THE COURT: My second question is - burden, standard of review. Do you agree with the government that this whole thing turns on factual conclusions.

YINGLING: No, Your Honor. The clearly erroneous standard does not apply in this case because there are clear errors of law. The Court below went outside of section 7428 when it made its determination on grounds that were not raised by the IRS in the final adverse ruling.

THE COURT: Okay, put that aside and come back to your other argument which is - that ah - he misapplied the operating test.

YINGLING: Right.

THE COURT: It that a factual problem.

YINGLING: No, it is not, Your Honor, that also is a question of error of law in that he misapplied the operating test under section 501(c)(3) of the Code, both of

those are errors of law and they are subject to plenary review in this Court.

THE COURT: By doing what again? Misapplication of the true legal test by doing what?

YINGLING: He misapplied the operational test under section 501(c)(3).

THE COURT: By doing what?

YINGLING: By failing to base - look to the entity's actual activities and actual operations in order to determine whether it operated in accord with section 501(c)(3).

THE COURT: But you really mean by failing to restrict himself only to looking at current operations. Isn't that really your position that he may not look more broadly.

YINGLING: Your Honor, he did not just fail to restrict (interruption) . . .

THE COURT: Yes or no. It is a yes or no question.

YINGLING: He did not just fail to restrict himself to the operations, Your Honor, he totally ignored them. He simply ignored the activities of this entity for five years, he simply ignored the record that the entity had compiled below and speculated that at some point in the future the entity (interruption) . . .

THE COURT: Well then, if you are saying he was allowed to look at the intellectual property rights but he also had to look at the archiving then your argument does become factual, cause now you're talking about how much weight he should have given to the one versus the other in which case I think that Judge Plager's suggestion is correct that it is a

factual matter and would be reviewable by a [inaudible] error.

THE COURT: It wasn't my suggestion but the government's.

YINGLING: I believe the Third Circuit addressed that question in the *Presbyterian Reform* case and it found specifically that if the lower court made the wrong factual inquiries that then became an error of law that was subject to plenary review. It was the exact same kind of situation.

In conclusion, if I can state, Your Honor, that the Court's decision below does a grave disservice to the sincere religious (interruption) . . .

THE COURT: We can conclude, your argument, your time is up and we thank you. This is submitted.